

# JAPAN AT THE CROSSROADS, INSULARITY OR INTERNATIONALIZATION

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People tend to think of the changes in the bilateral relationship with Japan from a U.S. perspective. However, current changes are as much or more a function of developments in Japan, developments that will affect its relationship with the world. Japan is now at an critical point in its history because it has become a large, advanced industrial nation. At this critical juncture, Japan stands at a crossroads with forces pulling it in conflicting directions. The choices Japan makes over the next several years will profoundly affect its relationship with the rest of the world. Should Japan choose a path of internationalization, it can promise to be a more useful and productive member of the world community. If, however, Japan chooses to follow a path of continued or intensified insularity, it could have a negative impact on the world.

## INSULAR JAPAN

What do I mean by insular Japan? Although this is a recurring theme in historical analysis of Japan,<sup>1</sup> the postwar period is of greatest interest here. There are three ways of looking at Japan's insularity: socially, politically, and economically. While the theme of this symposium is economics, it is worth looking briefly at all three.

In a general social sense, the Japanese have a strong desire to see themselves as unique in the world. Foreigners, especially westerners, are never completely accepted in Japanese society. Indeed, foreigners who have lived in Japan many years feel the exclusion more keenly than those who spend brief periods there. Japanese people have a willful desire to believe that foreigners can never truly understand their culture, language or customs. A whole theory of Japanese uniqueness, called *Nihonjinron*, or the theory of Japaneseness, has risen around this belief.<sup>2</sup>

Not far below the surface of this sense of uniqueness is a strong belief that Japan and the Japanese are superior to the rest of the world.<sup>3</sup> While the Japanese have had periods of admiration for other nations or cultures (most recently, the United States in the very early postwar period), contempt is an equally strong feeling. Feeding these beliefs is the fact that relatively few Japanese spent time abroad during the first 40 years after the end of World War II.

The second form of insularity is political. Partly because of American policy toward Japan during the occupation, and partly out of its own choice, Japan has avoided involvement in major international issues of the postwar era.<sup>4</sup> The postwar constitution renounces the use of

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<sup>1</sup> See Edwin O. Reischauer, *The United States and Japan* (New York: The Viking Press, 1965), pp. 99-115 for a standard analysis of Japan's insularity.

<sup>2</sup> Jared Taylor, *Shadows of the Rising Sun: A Critical View of the "Japanese Miracle"* (New York: Morrow, 1983), pp. 27-41 provides an accurate appraisal of this sense of uniqueness, written by a foreigner born and bred in Japan. Also see Harumi Befu, "Internationalization of Japan and Nihon Bunkaron," in Hiroshi Mannari and Harumi Befu, eds., *The Challenge of Japan's Internationalization* (Tokyo: Kodansha, 1983).

<sup>3</sup> Hajime Ohta, "New Views of Competition in the Japanese Economy," *Council Report*, No. 17, May 2, 1980, describes a new wave of Japanese economic research (exemplified by Professor Tsuneo Iida of Nagoya University) that sees Japan functioning better than the economies of other industrial nations. While Japan has done well, many of the conclusions of this research are quite exaggerated.

<sup>4</sup> Donald Hellman, *Japan and East Asia: The New International Order* (New York: Praeger, 1972), especially pp. 3-17 describes this characteristic of postwar Japanese foreign policy. Only in the late 1980s was Japan beginning to emerge from its relative isolation from major world issues.

military force, and though that constitution has been interpreted as allowing a sizable military establishment (roughly the fourth or fifth largest in the world), it remains in a firm defensive posture. Japan will not even send mine sweepers (a type of naval vessel possessed in considerable numbers) to help defend tankers carrying oil through the Persian Gulf to Japan.

Without any ability to project military power beyond its borders, Japan has had little effective voice in international affairs. Japan has followed the American lead on many international issues, but its support has rarely extended beyond relatively empty gestures—votes in favor of the United States at the UN, boycotting the Moscow Olympic games, or downgrading Japanese diplomatic relations with South Africa. Instead, Japan has dealt with the rest of the world mainly in commercial terms. The dominant, policy-making elites care little about who governs other countries, human rights, revolution or starvation, so long as other nations are willing to trade. Japanese corporations (often with the implicit or tacit approval of the Ministry of International Trade and Industry) have been willing to sell high technology to the Soviet Union, or become South Africa's leading trading partner, and the government was willing to make pro-Arab statements in the wake of the oil shock of 1973 to guarantee the continued flow of oil. Pressure or criticism from the United States and others has forced Japan to retreat from some of these activities.

Because Japan has kept its relations with the rest of the world on a commercial level, it has effectively avoided any of the cost or pain of participating in the critical issues of the world for the past 40 years. Aside from those in the Japanese government, or the business sector who deal with the world professionally, the degree of ignorance about world events is quite remarkable. This is even more remarkable given the extensive exposure to international news that the average Japanese experiences in the media.

The third form of insularity is economic. This sounds like a strange characterization for a nation that is a successful exporter to the rest of the world. But the entire history of Japan's economic development since the 19th century has been a determinedly nationalistic one, aiming at a Japan owned, operated, and supplied by Japanese firms.<sup>5</sup> The value-neutral economic term for this is "import substitution." For the past century, Japan had endeavored to substitute domestic production (by Japanese-owned firms) for imports. Foreign products have been tolerated or accepted only so long as Japan could produce a comparable product.

How have these attitudes affected Japan's economic relationship with the rest of the world?

(1) The early postwar period was characterized by very high tariffs, stringent quotas, unusually strict standards and biased inspection procedures all designed to keep out unwanted foreign products.<sup>6</sup> These barriers have been slowly falling since the early 1960s, but they remain remarkably and annoyingly strong.<sup>7</sup>

<sup>5</sup> Chalmers Johnson, *MITI and the Japanese Miracle* (Stanford: Stanford University Press, 1982) is a thorough discussion of this aspect of Japan with a focus on the postwar period. One need not entirely accept his thesis that the Ministry of International Trade and Industry was responsible for Japanese economic success to appreciate the extensive and nationalistic bent of industrial policy.

<sup>6</sup> On the early postwar history of trade barriers in Japan, see Warren Hunsberger, *The United States and Japan in World Trade* (New York: Harper and Row, 1964).

<sup>7</sup> There has been considerable debate among specialists about the impact of Japanese trade barriers. Clyde Prestowitz, *Trading Places: How We Allowed Japan to Take the Lead* (New York: Basic Books, 1988), pp. 73-184, gives a thorough examination of how Japan continues to behave in a protectionist manner. Even those who doubt that Japan is highly protectionist find significant amounts of trade are blocked: C. Fred Bergsten and William Cline, *The United States-Japan Economic Problem* (Washington: Institute for International Economics, 1985) estimated that complete removal of Japanese barriers would lead to an expansion of U.S. sales to Japan by \$5 to \$8 billion (added to the existing level of exports at that time of \$20 billion).



(2) Japan has responded to its responsibilities within the two major multilateral trade organizations to which it belongs (the General Agreement on Tariffs and Trade—GATT—and the Organization for Economic Cooperation and Development—OECD) without any vigorous, domestic free trade lobby. Both organizations are based on the fundamental proposition that removing trade barriers is in the interest of nations that do it. Whereas Americans support free trade as an ideology (if not as a practice), because they agree with this proposition that liberalization yields overall benefits for the nation, Japanese support free trade only because failure to at least partially meet international obligations could lead to retaliation against Japan's exports. This is a particularly weak argument, and a very narrow way to look at the world.<sup>8</sup>

(3) Economic policy has been guided by a desire to produce everything at home. Tariffs, quotas, standards, inspection procedures, government loans, relaxed antitrust policy and research support have all been used to guarantee that Japan could replace most imported products.<sup>9</sup> Although the scope of these policies has been reduced in recent years, the attitudes and many of the policies persist—especially for any product considered important for the future economic prowess of the nation (a category that currently includes semiconductors, computers, robotics, new materials and other high-technology products). All advanced nations, including the United States, have an interest in new, high-tech industries and technologies. But the array of policies in Japan goes far beyond those used by the United States. Furthermore, policies in Japan have a commercial focus, whereas government to emerging industries and companies in the United States is often an unintended side benefit of defense requirements.<sup>10</sup>

(4) Japan has engaged in relatively little direct foreign investment. Until the late 1960s, very few Japanese firms could invest abroad, and even by the late 1970s most investments were either raw material development projects or commercial investments, (i.e. investments related to the sale of Japanese products) rather than in manufacturing.<sup>11</sup>

(5) Japanese business, government, and public sectors have had a firm commitment to the idea of comparative advantage, but not to the idea of intra-industry trade (that is, imports and exports of similar products). Because of product variety and the existence of market niches, among other factors, the world is characterized by a high level of two-way trade in similar products.<sup>12</sup> Indexes of intra-industry trade, however, remain very low for Japan when compared to other industrial countries. Not only are they low on average, but Japan's lack of intra-industry trade adversely affects many of the leading American exports. The Japanese response to such facts is not embarrassment or guilt, but puzzlement: why should they want to import something that they can manufacture at home?<sup>13</sup>

<sup>8</sup> Even a recent major Japanese policy statement couched the need to continue removing trade barriers in these terms. *The Report of the Advisory Group on Economic Structural Adjustment for International Harmony*, April 7, 1986, focuses on policies to bring about "international harmony," as the group's name implies. The report makes virtually no mention of any benefit to Japan itself from the increased economic efficiency that comes from more open trade.

<sup>9</sup> Philip Trezise and Yukio Suzuki, "Politics, Government, and Economic Growth in Japan," in Hugh Patrick and Henry Rosovsky, eds., *Asia's New Giant*, pp. 783-811, discuss the use of industrial policy for a broad array of industries, some of which were foolish for Japan to enter.

<sup>10</sup> Richard Levin, "The Semiconductor Industry," in Richard R. Nelson, ed., *Government and Technical Progress: A Cross Industry Analysis* (New York: Pergamon Press, 1982), illustrated these differences nicely, as does Kenneth Flamm, *Creating the Computer: Government, Industry and High Technology* (Washington: The Brookings Institution, 1988).

<sup>11</sup> Even as recently as 1986, only 27 percent of Japan's cumulative foreign direct investment was in manufacturing, while 30 percent was in commerce and finance (Ministry of Finance, *Okurasho Kokusai Kin'yu Nenpo*, 1987 edition, pp. 456-7). This is a pattern that demonstrates Japan's position as a trading nation: preferring to produce at home and export to the rest of the world. The United States had a much higher 41 percent of its foreign direct investment in manufacturing as of 1983 (Department of Commerce, *Statistical Abstract of the United States*, 1987 edition).

<sup>12</sup> Products or industries are difficult concepts to define, but extensive intra-industry trade exists even at a 4-digit level of product classification in the widely used SITC classification. At this level, passenger cars are a single category, as are buses, specialty vehicles, and automotive parts.

<sup>13</sup> Robert Z. Lawrence, "Imports in Japan: Closed Markets or Closed Minds?" *Brookings Papers on Economic Activity*, 1987, No. 2, reviews this evidence.

(6) Japan has been adept at absorbing technology from the rest of the world, but has given very little in return. Japanese laboratories remain relatively closed to foreigners, and Japan continues to run a deficit in its balance of payments on licensing fees, despite its status as an advanced industrial nation.<sup>14</sup>

(7) Japan has given foreign aid to developing countries, but that aid retains a strong mercantilist orientation. While this is somewhat less true today than 10 years ago, the main purpose of Japanese foreign aid remains the commercial gain of Japanese companies, or the enhancement of raw material supplies from developing countries to Japan.

## RECENT ECONOMIC CHANGES

The picture drawn above of Japan's economic relationship with the world has characterized most of the postwar period. However, in the past several years new economic events have brought Japan to the critical crossroads where it is today.

First, Japan has completed the process begun a century ago of catching up with industrialized countries. Now that Japan is at the technological frontier, it can no longer rely entirely on importing and adapting foreign technology. Also, the success of its development means that income levels in Japan are as high or higher than those in the United States; Japan no longer has any economic reason to feel inferior to the industrial nations.<sup>15</sup>

Second, the 1980s brought a set of macroeconomic conditions in Japan that led to massive net outflows of capital. Once the nation completed its process of catch-up, the rate of economic growth slowed. Growth is fueled by investment, so that slower growth implied lower rates of investment. This slowdown took place, however, in the context of a society that has high levels of savings. Even though savings have also diminished somewhat, the drop in investment was larger, leaving a surplus of savings over investment in the private sector. That surplus had to be absorbed somewhere in the economic system, or it would lead to recession. During the 1970s, the government absorbed the surplus by running fiscal deficit (soaking up the extra savings from the private sector by issuing government bonds). During the 1980s, however, the government deficit shrank, and the rest of the world became the outlet for Japan's surplus savings.<sup>16</sup>

This above development appeared as a rapidly rising, current account surplus and offsetting of net capital outflow. From a deficit or current account in 1980 of \$11 billion, Japan moved swiftly to a record surplus of 86 billion dollars by 1986. The accumulation of net capital outflow has now pushed Japan to the position of being the largest net creditor in the world, with accumulated net assets of 180 billion dollars in 1986, and probably rising to about 240 billion dollars by the end of 1987.<sup>17</sup> Much of this investment has been in the form of portfolio investments, but there has also been a rising amount of foreign direct investment.

Third, the yen has risen sharply against the dollar since 1985. From ¥260 in February 1985, the yen has risen to its current level of approximately ¥130, a rise of over 100 percent.

<sup>14</sup> Bank of Japan, *Balance of Payments Monthly* No. 260, March 1986, pp. 29-30, shows a rising deficit on patent royalties from just under \$1 billion in 1980 to \$2.5 billion by 1987. This is a remarkable development for a nation that had moved to the technological frontier in many industries.

<sup>15</sup> Barry Bosworth and Robert Lawrence, "America's Global Role: From Dominance to Interdependence," xerox paper, July 1988, p. 25, notes that when the comparison of per capita income is made on the basis of purchasing power parity exchange rates (rather than the nominal market rates), Japan is now 71 percent of U.S. GDP per employed person, putting it in the range of most European nations.

<sup>16</sup> For a detailed discussion of these relationships, see Edward J. Lincoln, *Japan: Facing Economic Maturity* (Washington: The Brookings Institution, 1988), especially pp. 69-129.

<sup>17</sup> Bank of Japan, *Balance of Payments Monthly*, April 1988.



This is an enormous currency movement in a short period of time, and it holds important implications for Japan. Most important, Japan's large current-account surpluses will shrink; even though this development has been slow to materialize, few economists doubt that it will happen.<sup>18</sup> Therefore, Japan can no longer rely on increasing exports as an engine for economic growth; it must seek ways to expand domestic demand. In addition, the currency movement has made the prices of many internationally traded goods much lower than prices for comparable products in Japan.

These developments cannot be overemphasized. Japan's emergence as an economic equal of the United States and Western Europe brings to a close a century of determined efforts to catch up. Attitudes, policies and behavior patterns that were rational responses to that goal are no longer appropriate or useful. Japan's concurrent movement to creditor status puts the nation in a position that it has not experienced since it was a colonial power prior to the world. Investments must be managed, and the world awaits Japanese initiatives in that management. The strong yen is also a new development. Movement in that direction in 1972-1973, and again in 1977-1978, was truncated by the ensuing oil shocks. This time no oil shock is likely, and the yen should remain very strong for the indefinite future. Japanese business and the public are finally realizing this and beginning to adjust.

### INTERNATIONALIZATION

The events sketched above lead to a scenario of increasing internationalization for Japan, drawing it out of its shell of insularity. Some indications that Japan is moving in this direction are beginning to appear.

Being a major creditor involves a nation much more intimately with the world than does interacting mainly through exports. Japan must necessarily become genuinely concerned about the economic health of the rest of the world, because Japanese investments are at stake. Whether it wants to or not, Japan cannot remain as aloof from the issues of the day as it has over the past 40 years.

This greater concern with the world has a personal aspect; assets require people to manage them, and Japanese businessmen have been pouring out to other countries. Taking their families with them, these people represent a dramatic increase in the number of Japanese with extensive foreign experience.<sup>19</sup> Their outlook on world events and on Japan's role in the world tends to be considerably more cosmopolitan than those who have not had this experience. Furthermore, children are probably more affected than their parents. There are now so many children returning to Japan from extended international living experience that the Japanese educational system cannot such push them aside, as it used to do. Some Japanese universities even welcome or solicit students with foreign experience.

Finally, the rise of the yen has made people acutely aware of the cost of pursuing an insular, nationalistic set of commercial policies. When the price of rice is four to five times the level of world prices, and beef is seven to eight times world prices, people begin to

<sup>18</sup> The yen began to rise in 1985, but the dollar-denominated current-account surplus continued to rise until 1987 (when it peaked at \$87 billion). Forecasts for fiscal year 1988 (April 1988 to March 1989) are for a modest decline, and data for the first half of calendar 1988 confirm a slow downward trend.

<sup>19</sup> According to Japanese statistics, the total number of Japanese nationals travelling abroad rose from 3.9 million in 1980 to 4.9 million in 1985, a 27 percent growth. The number leaving for longterm business assignments rose from a miniscule 13,000 in 1975 to 37,000 in 1980 and 57,000 by 1985, a 56 percent jump for the 1980-1985 period. *Japan Statistical Yearbook*, 1986 edition, p. 61.

question the value or need for continued protectionist policies. At the industrial level, even Japanese firms, with their legendary loyalty to long-term domestic suppliers, are willing not to turn to imports when the price differential passes some threshold. Current exchange rates appear to be sufficient to generate that switch in loyalty, although the process may take some time. Another way of putting this is that Japan may be facing the emergence of a true domestic lobby in favor of free trade. Imports are favored because they represent reduced prices, and allow structural adjustment to take place with disinvestment in uncompetitive industries. Within a few years, Japan will even begin importing foreign rice, perhaps the most symbolic of all products.<sup>20</sup>

## INSULARITY

If Japan is at a crossroads, then there must be another trend affecting the nation. Indeed, there are some very worrisome developments, or lack of developments in Japan.

Japan is a nation with a hierarchical society.<sup>21</sup> The sense of hierarchy that pervades domestic and social relations extends to Japan's view of the world. Within that hierarchical system, relationships of true equality are very rare; most relationships are between inferiors and superiors. The sense of hierarchy within Japanese society is also projected on the world; the Japanese tend to think of the relationships among nations in the same hierarchical terms that they view their own personal social relationships. For the past century, Japan has willingly accepted its role as an inferior (except in the 1930s and 1940s). Now that it has truly joined the advanced industrial nations, Japan is unwilling to see the relationship as one of equality; the Japanese want to see themselves as the superior, and wish to push the rest of the world into the category of inferiors. This attitude is becoming so widespread that most of my own meetings with the Japanese begin with their presentation of the assumption that the United States is a waning industrial power with inferior quality, labor, technology, commitment to work and even inferior intelligence.<sup>22</sup> While the United States does have its share of problems, the Japanese view is becoming wildly exaggerated.

Entering a new phase of intensive involvement (with the world at a time when unrealistic arrogance is becoming commonplace), represents an unfortunate development for Japan. Older Japanese government officials, who also felt considerable contempt for other nations, were at least willing to make concessions out of their sense of economic inferiority. Younger Japanese officials, however, have all of the arrogance and none of the deference.

Second, the Japanese could make themselves unwelcome as creditors. They have an ability to pick out the most conspicuous acquisitions—the Tiffany building in Manhattan, Firestone tires, Van Gogh paintings, and million dollar homes in Honolulu. They are earning a reputation for driving up prices and maintaining a high profile. The appreciation of the yen

<sup>20</sup> The breakdown in the determined reliance on domestic suppliers has been the topic of frequent articles in the weekly business magazines over the past three years. See for example, "Endaka Kakumei De Nihon Wa Ko Kowaru" (Japan Will Change Like This Under the Strong Yen Revolution), and "Kyuzo Suru Yu'nyuhin To No Kyoson wa Kanno Ka?" (Is it possible to coexist with the Rapid Increase In Imports?), *Toyo Keizai*, January 23, 1988; or "Hirogaru Seihin Yu'nyu Kuyzo No Impakuto" (The Impact of the Rapid Rise in Manufactured Imports), *Toyo Keizai*, July 4, 1987.

<sup>21</sup> Hierarchy is pervasive in all social relationships in Japan. For a discussion of Japanese society and how it operates, see Chie Nakane, *Japanese Society* (Berkeley: University of California Press, 1972).

<sup>22</sup> The remarks made by then-Prime Minister Nakasone about blacks and hispanics in the United States (*New York Times*, September 23, 1986) is also typical of this attitude. The criticism of his remarks in Japan stemmed not from their content, but from the fact that they damaged relations with the United States.



has exacerbated this trend by making foreign acquisitions appear more inexpensive from the Japanese standpoint. The Japanese could make themselves even more unwelcome than did Americans around the world in the early postwar period.

In the area of direct investment, the Japanese also run into problems because of their asset management. Although the principal reaction has been to welcome Japanese management techniques and technical efficiency, there is also a less pleasant side to Japanese management. More management slots are reserved for Japanese nationals than Japan reserves for the overseas subsidiaries of other nations, a pattern shown in numerous studies of foreign investment.<sup>23</sup> The Japanese have also carried with their bias against women in managerial positions. These practices have already led to lawsuits and discontentment among the American employees of Japanese-owned firms in the United States, a trend which could become stronger.

These investments create another problem as well. Japanese firms coming to the United States are now pulling their suppliers along with them, keeping their traditional relationships, and freezing out American firms who find that the lack of open access to markets in Japan is now invading the United States. The protests from the automobile parts industry are already being heard in Congress.

Finally, it is not at all clear how much Japanese attitudes about economic nationalism have changed. Import barriers may fall, but ultimately it is doubtful if Japanese business government will become fully committed to free competition and free trade. The United States keeps pushing Japan to take more of a leadership role in international trade, but fundamentally, Japan does not share American ideals about the desired nature of that system. A world in which Japan plays a dominant role in shaping international trade policy would be a world of heavily managed trade, a world of cartel arrangements that would be worked in Japan's favor to the maximum extent possible.<sup>24</sup>

## CONCLUSION

Where will Japan go? The promise and opportunity of Japanese internationalization is quite real. The cautions sounded above are equally real. I tend to be somewhat pessimistic. Favorable changes will take place, but Japan is likely to remain a relatively insular nation, more involved with the world, but sticking to its sense of uniqueness, superiority and arrogance. This means that we face serious problems over the next several decades, because American's patience with this new Japan will continue to diminish. Any serious break in the bilateral relationship remains unlikely, but not inconceivable. The reality that Japan relies on the United States as the market for 38 percent of its exports, or that the United States is dependent on Japanese financial capital, does not preclude the possibility of angry reactions in one or both countries in the future. This could move Japan away from its close bilateral relationship.

<sup>23</sup> See, for example, Noritake Kobayashi, "The Patterns of Management Style Developing in Japanese Multinationals in the 1980s," in Susumu Takamiyama and Keith Thurley, eds., *Japan's Emerging Multinationals* (Tokyo: University of Tokyo Press, 1985); or Robert Marsh and Hiroshi Mannari, "The Internationalization of Management in Japanese Multinationals," in Hiroshi Mannari and Harumi Befu, eds., *The Challenge of Japan's Internationalization: Organization and Culture* (Tokyo: Kodansha, 1983).

<sup>24</sup> Prestowitz, *Trading Places*, is an eloquent testimony to the fact that even the 1980s, very basic mercantilist attitudes and policies are continuing. Unfortunately, Prestowitz would have the United States respond by adopting a policy of managed (cartelized) trade with Japan.

What can we do? The critical elements to dealing with Japan as it faces this historic time in its history are three-fold:

(1) Engagement. We must remain closely involved with Japan, and try to nudge it along a more international path. Indeed, the United States hardly has any choice. Angry rejection of Japan, in the form of serious controls on imports or Japanese investment in the United States, would be quite foolish. Furthermore, more Americans must learn the Japanese language, and develop an understanding of Japanese culture. Even today, the number of such specialists in the Federal government, and in American manufacturing, is appallingly low.

(2) Domestic responsibility. We have earned at least some Japanese contempt aimed at the United States. The United States must reduce the federal deficit as part of the effort to reduce the current-account deficit, and the large net inflow of Japanese capital that comes with it.

(3) Tough but reasoned pressure. The Japanese are tough, shrewd negotiators. They understand strength and pressure, and they respond to little else. The United States must be willing to use retaliatory tactics in negotiating with Japan, in order to push Japan in a more international direction. A rising free trade lobby in Japan may eventually make this unnecessary, but until that time comes, sharp and painful pressure must be a tool in that process.

If the United States is willing to do these things, there will be a rough but manageable bilateral relationship. Japan must go through a transition, and develop a more international set of attitudes and policies. If we do not remain engaged, control the U.S. deficits, and keep reasonable pressure on Japan, then there is no guarantee what will happen over the next two decades.



## 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

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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.<sup>1</sup>

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:

<sup>1</sup>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:<sup>2</sup>

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:

<sup>2</sup>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.<sup>3</sup>

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.<sup>4</sup>

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.<sup>5</sup>

<sup>3</sup>Karel G. van Wolferen, "The Japan Problem," *Foreign Affairs*, Winter 1986-87, pp. 289-290.

<sup>4</sup>Chalmers Johnson, *MITI and the Japanese Miracle* (Stanford, CA: Stanford University Press, 1982), pp. 19-20.

<sup>5</sup>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."<sup>6</sup> 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.<sup>7</sup> 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 ascendancy), 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

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

<sup>7</sup>See, for example, Clyde Haberman, "Some Japanese (One) Urge Plain Speaking," *New York Times*, March 27, 1988, p. 1-3. 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 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.<sup>8</sup>

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.<sup>9</sup> 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

<sup>8</sup>Robert B. Reich, *The Next American Frontier* (New York: Penguin Books, 1983), p. 141.

<sup>9</sup>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.<sup>10</sup> 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."<sup>11</sup> 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.<sup>12</sup>

<sup>10</sup>"A Made-in-Japan Mistake," *Newsweek*, October 17, 1983, p. 25.

<sup>11</sup>Semiconductor Industry Association, "One Year of Experience Under the U.S.-Japan Semiconductor Agreement," September, 1987, p. 1.

<sup>12</sup>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.<sup>13</sup> 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.

<sup>13</sup>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."<sup>14</sup>

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.

<sup>14</sup>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.



## U.S.-JAPAN RELATIONS: GROWING INTERDEPENDENCE

Douglas Ostrom\*

What a difference a few years make. A few years ago, Ford Motor Company and other American automakers were locked in a fierce battle with their Japanese counterparts. Japanese manufacturing costs were said to be lower and the quality of the cars higher. U.S. makers disputed these claims, insisting that quality differences were cosmetic at best, and sometimes suggested that most or all of the Japanese advantages were consequences of unfair trading practices. It seemed to be a war which the United States was losing.

Since this war began, companies in both countries have had brushes with bankruptcy. In the United States, Chrysler Corporation required a government-guaranteed loan in the early 1980's to stay in business. Japan's Toyo Kogyo Company, Ltd., maker of Mazda, got help from its leading bank, Sumitomo Bank, Ltd. after its rotary-engine cars proved unpopular at the time of the 1973-74 energy crisis. Sumitomo dispatched executives to bring Toyo Kogyo back from the brink. Both companies had returned to financial health by the mid-1980's. If Mazda was closely identified with its leading bank in the 1970's, today its leading partner appears to be none other than one of its former rivals, Ford Motor Company. While Sumitomo Bank now apparently feels a little like a jilted lover, Ford and Mazda's relationship, like many marriages, has its ups and downs but still seems to be getting stronger over time. Ford has, for example, reportedly assigned to Mazda major responsibility for engineering work on its not yet introduced U.S. small car line. This line will probably replace the popular Ford Escort and is responsible for distributing the Mercury Tracer, a product of Mazda engineering and Mexican labor. In a sentence, Ford has become dependent on Mazda. Sumitomo's displeasure with Mazda apparently reflects its belief that Mazda relies on Ford. This mutual dependence serves as a metaphor for the two nation's economies. While far from full realization, this interdependence could become one of the major themes of the closing years of this century.

While the argument is usually that the United States depends on Japan, the relationship goes both ways, as the following examples will show.

### INTERNATIONAL FINANCIAL LINKAGES

"When America catches cold, Europe or Japan gets pneumonia." This old expression is still true: exports, while not as critical as in some other economies, still play an important role in Japan. When the yen started appreciating against the dollar in early 1985, Japanese companies had to either raise prices, reduce overseas sales, or accept lower profits. They did a little of each, with the result that unemployment rose and profits in export-dependent industries plummeted. A severe recession in the United States would also have led to more unemployment in Japan.

Increasingly, the economic virus can cross the Pacific in the other direction. According to Japanese government data, Japanese firms and individuals purchased \$49.4 billion (net of redemptions) of U.S. private and government securities in 1986, the latest year for which data is available.<sup>1</sup> Much of this went into U.S. government securities to help to finance the U.S.

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<sup>1</sup>Bank of Japan, *Balance of Payments Monthly*, April 1987, p. 79.

government deficit. The result was that Japanese funds directly and indirectly financed perhaps a quarter of that deficit. Were these funds not available, the government would have to pay higher interest rates to attract the funds from somewhere else, putting more pressure on the deficit or creating pressures for higher taxes. In addition, borrowers ranging from home buyers to U.S. corporations wanting to expand would also pay higher rates. Some would choose not to pay the higher rates, leading to lower overall investment. Thus, Japanese funds enable higher levels of investment by American companies. In turn, some of this investment strengthens the ability of U.S. firms to compete with Japan.

The deepening financial interdependence of the United States and Japan (and incidentally of other industrial countries) was dramatically illustrated by the events of 1987. The Group of Seven industrial nations (the United States, Japan, West Germany, France, the United Kingdom, Italy and Canada) agreed in early 1987 to stabilize the value of their currencies in an agreement that has become known as the Louvre Accord. An essential corollary was that interest rate policies would also be coordinated; otherwise, differential movements in these rates would create changes in the demand for currencies, leading to exchange rate instability.

Things went well at first, but in the early fall of 1987, the Americans and the Germans disagreed about which way interest rates should go. Already uneasy for a variety of reasons and sensing exchange rate instability and possibly higher interest rates, the stock markets panicked, sending equity prices sharply lower in New York, London, Tokyo and elsewhere.<sup>2</sup> The dollar went into a deep dive that lasted until early January 1988.

At this writing in mid-1988, there continues to be a sense of unease in both the currency and stock markets towards a possible recurrence. American security analysts, anxious about foreign investors pulling their money out of this market, keep a wary eye on large Japanese institutions, as well they should. Aside from less liquid, direct investment in factories, real estate and the like, Japanese public and private investment in the United States at the end of 1987 was an estimated \$164 billion out of a total foreign indirect investment of \$1.3 trillion.<sup>3</sup> Should Japanese and other foreign investors quickly withdraw from the bond or equity markets, the market meltdown of 1987 would seem like a minor accident.

Banking illustrates another of the ways in which financial linkages between the United States and Japan are deepening. For a variety of reasons, Japanese banks, now the world's largest with 12 of the 20 largest positions as measured by assets, have moved into the United States in a big way. While most obvious in California and New York, the main places where subsidiaries serve the public, they are important providers of financial services to government and corporations throughout the country.<sup>4</sup> According to the Federal Reserve Board, Japanese banks had 9 percent of all outstanding loans to government, corporations, and individuals in the United States as of June 1987. At the end of 1983 the figure had been only 5 percent, leading to fears of increasing international friction over this issue.<sup>5</sup>

<sup>2</sup>The Japanese however added to their stock holdings in 1987 while Americans and the British were reducing theirs, according to Salomon Brothers International, Ltd.

<sup>3</sup>Calculated from data in U.S. Department of Commerce, *Survey of Current Business*, June 1987 and March 1988 issues.

<sup>4</sup>For details, see the Japan Economic Institute publication "Japanese Banks in the United States," *JEI Report* No. 3A, January 22, 1988.

<sup>5</sup>*Nihon Keizai Shimbun* (Japan Economic Journal), March 12, 1988, p. 1. These figures to some extent double-count the figures on indirect investment above to the extent that Japanese banks finance their U.S. activities with Japanese funds.



## TECHNOLOGY

While at one time United States industry clearly had the most advanced technology in the world, that is no longer always the case. While data on patents is notoriously unreliable, some of the latest evidence is at least suggestive. The Patent and Trademark Office reports that in 1987, foreigners accounted for 46.6 percent of all patents issued in the United States, a figure which has doubled in the past twenty years. The Japanese received more U.S. patents than anyone else, accounting for 19.3 percent of total patents issued. The percentage of all patents awarded to Japan has doubled in under ten years. Three Japanese companies, Canon Kabushiki Kaisha, Hitachi, Ltd. and Toshiba Corp. were the top three corporate recipients, all finishing above General Electric Co., which had been first until 1986.<sup>6</sup>

To the extent that technology makes life better, Americans benefit from the Japanese, either in imported products that embody the new technology or by licensing agreements that permit the use of products produced in America. If technology is a critical part of products or services which we value highly, we become dependent on it.

Levitation transportation technology (maglev) could become such an example. Maglev uses superconductivity as a means to help propel trains at speeds as fast as 300 miles per hour. In addition to speed, it is potentially extremely safe, quiet and in some respects cheaper than conventional technology.<sup>7</sup> Amtrak, the national rail passenger corporation, has expressed an interest in using Maglev for transporting people between airports and population centers, thereby permitting a wider dispersion of airline traffic.<sup>8</sup> While the United States debates whether to fund research for the project,<sup>9</sup> Japan and West Germany have developed experimental prototypes. Allegedly, Japan is ready to move toward the first truly operational system.<sup>10</sup> While the benefits of the technology are obvious, it is not clear how the United States could compete. There are said to be no U.S. companies capable of developing the new technology, and Amtrak is severely strapped for funds. Using German or Japanese firms to develop a system for the U.S. would be an easy way to recap the benefits for U.S. travelers.

Better technology exchange is only one reason why, at the corporate level, Japanese and American firms are developing closer links. Japanese automobile firms now generally have design staffs in the United States to better use American design talent and to stay tuned in to trends in this country, its most important overseas market. The dependence of Ford on Mazda for engineering, design and products has already been noted. The International Trade Commission estimates that the Big Three U.S. automakers imported \$5.6 billion of parts in 1986, accounting for 6 percent of the trade deficit that year.<sup>11</sup> Many of these parts came from Japan.

<sup>6</sup>"Foreigners Received Nearly Half of all Patents Issued Last Year, PTO Reports," *Daily Executive Report*, February 29, 1988, p. A-2.

<sup>7</sup>See article by Masaru Ibuka, Honorary Chairman, Sony Corp., "'All Aboard' the Floating Train," *Sankei Shimbun*, May 9, 1988.

<sup>8</sup>Telephone conversation with Amtrak official, March 1, 1988.

<sup>9</sup>See for example, "U.S. Dropping Behind Japan in High Speed Transportation Technology, Senate Told," *Daily Report for Executives*, February 29, 1988, p. A-5.

<sup>10</sup>*Ibid.*

<sup>11</sup>*Washington International Communications* (American International Automobile Dealers Association), February 19, 1988, p. 5.

For U.S. companies, competing against Japan increasingly means using Japanese companies as partners or suppliers. Sometimes, U.S. policies intended to protect U.S. companies by making life difficult for Japanese makers end up damaging American companies. The 1986 semiconductor accord and its consequences are a case in point. The purpose of the agreement negotiated at Washington's request, between the United States and Japan, was to establish minimum prices for computer chips sold by Japanese makers in the United States and in third world countries. It was hoped American makers would benefit by being able to sell their own chips at higher prices, while Japanese manufacturers would sell fewer chips at steeper prices.

After the agreement was signed in August 1986, Japanese companies, with the support of the Japanese government, reduced exports, believing that with higher prices fewer chips could be sold. Between late 1986 and early 1988, however, demand for the chips boomed. American users of Japanese chips, including personal computer makers, suffered because they could not get a supply at a reasonable cost. Japanese personal computer makers could supply themselves with chips, ending up in a superior competitive position as a consequence of the accord the Americans had insisted upon.

### DIRECT INVESTMENT

Direct investment—buying a controlling interest in a new or established enterprise—is closely related to technology transfer. Japanese direct investment in the United States totalled about \$30 billion at the end of 1987,<sup>12</sup> spread among manufacturing, real estate and other activities. Sometimes, the investment takes the form of building new facilities, as with Toyota's automobile plants in Kentucky; other times it involves buying existing facilities.

Direct investment has another distinguishing characteristic: it involves many people. Japanese manufacturing firms alone employed about 135,000 in the United States at the end of 1986, according to the Japan Economic Institute.<sup>13</sup> In small communities, the effect of a new Japanese factory can be enormous. The effect, of course, is more than in just the numbers of people. While the data is sketchy, direct investment also leads to international technology transfer.<sup>14</sup> Some of the technology, as well as management styles and quality specifications, may spill over into domestically-owned firms. As Japanese firms move more production overseas in response to the soaring yen, the United States is likely to get a big chunk of the most technologically sophisticated investment, speeding the transfer process.

Important as the Japanese direct investment is, the Japanese are not the leaders, accounting for only 12 percent of the total investment outstanding in 1987.<sup>15</sup> In 1986, the last year for which comparable data is available, Japan was well behind the United Kingdom, which had more than twice as much investment, and the Netherlands, which had nearly twice as much.<sup>16</sup>

<sup>12</sup>Calculated from data in *Survey of Current Business*, June 1987 and March 1988.

<sup>13</sup>Susan MacKnight, *Japan's Expanding Presence: 1986 Benchmark Survey*, (Washington, DC: Japan Economic Institute, 1987).

<sup>14</sup>U.S. Congress Office of Technology Assessment, *International Competition in Services*, OTA-ITE-328 (Washington, DC: U.S. Government Printing Office, July 1987, pp. 191–221).

<sup>15</sup>Calculated from data in U.S. Department of Commerce, *Survey of Current Business*, June 1987 and March 1988.

<sup>16</sup>U.S. Department of Commerce, *Survey of Current Business*, August 1987.



If Japanese and other foreign investment has an important role in the United States, the effects in Japan may be even greater. As Japanese firms build factories abroad, new concerns are arising about the "hollowing out" of the Japanese industrial structure, a situation in which much of Japanese manufacturing would be done abroad, leading to much higher unemployment at home. So far that has not happened: it is still far more influenced by macroeconomic conditions than by increasing foreign investment. According to Japan's Ministry of International Trade and Industry (MITI), in fiscal 1986 which ended March 31, 1987, overseas production as a percentage of total production by Japanese manufacturers was only 3.2 percent. MITI estimates that the figure reached 3.7 percent in fiscal 1987.<sup>17</sup>

### JAPAN'S ROLE IN MARYLAND

If the United States and Japan have, at least in the past, engaged in economic war, Maryland has been among the battlegrounds. Two of the leading manufacturing industries represented in the Baltimore area, steel and automobiles, have endured Japanese competition for nearly two decades. While the effect of Japanese competition on the operations of Bethlehem Steel and General Motors in the Baltimore area is particularly difficult to assess, many Marylanders feel victimized. Consider the recent comments of the Congresswoman Helen Bentley who represents the district around the two plants:

Behind this massive penetration of foreign markets is a system which can best be described as economic totalitarianism, a government-directed enterprise in which all the energies of Japan have been mobilized to overwhelm the world competition. It is a national conspiracy directed from a central command post, a squat 11-story building in central Tokyo, the headquarters of MITI, the Ministry of International Trade and Industry

... The Japanese themselves have termed their centrally run operation the "Bureaucratic-Industrial Complex," one that is becoming as potentially dangerous to world stability as the military-political threat of the Soviet Union.<sup>18</sup>

The Congresswoman sees the situation as virtually an undeclared war. Many would take issue with her description of the Japanese economy as centrally directed; however, there is no denying the intensity of her feeling. Nor can one deny that jobs have been lost in Maryland as Japan has expanded its markets in this country. It is altogether different to deny that for Maryland, there are significant benefits to doing business with Japan. For one thing, there are the benefits produced by Japanese products. Thousands of Marylanders drive Japanese cars, believing them to offer better value than the domestic competition. Depriving drivers of that choice would reduce their sense of well-being. For other products the benefits are even clearer: video cassette recorders as a mass-market consumer product are the consequence of Japanese ingenuity. While few would argue that VCRs are absolutely necessary, millions nationwide find them a welcome addition to their homes. Japanese medical products help the sick get better and the aged lead more comfortable lives.

Almost adjacent to the beleaguered auto plant and steel making facilities in Baltimore is a powerful source of foreign trade-related job-creation, the Port of Baltimore. The port estimates that in 1984 automobile-import employment alone created 1,163 jobs.<sup>19</sup> While the

<sup>17</sup>*Nihon Keizai Shimbun*, April 22, 1988, p. 5.

<sup>18</sup>Comments of Helen Bentley in the *Congressional Record*, March 1, 1988, p. H540.

<sup>19</sup>Telephone interview with Jim Hobson of the Port of Baltimore, March 1, 1988.

Port doesn't provide a breakdown by automaker or nationality, it's no secret that most of that was Japanese. In 1986, the port did \$3 billion worth of business in Japanese imports, two-thirds of which was in automobiles.<sup>20</sup>

While much smaller than in several of the West Coast states, Japanese manufacturing firms have set up shop in Maryland, or acquired American firms with Maryland plants. The largest Japanese majority-owned manufacturing employer in the state is Locke Insulators, which employs 400 people in Baltimore. Terumo Medical Equipment of Elkton has 230 people on its payroll, while Shimadzu Scientific Instruments of Columbia has 80. In addition, Sun Chemical, a subsidiary of Dai-Nippon Ink, has a factory in Williamsport.<sup>21</sup> No Japanese bank at the time of this writing has an office to perform banking functions in Maryland.

In short, while the economy of Maryland can feel the cold wind of Japanese competition, some warm breezes do come this way. If, as the Congresswoman suggests, the economic relationship amounts to a war, it is a most peculiar one, with the Japanese side contributing in many ways to the American's continued ability to do battle.

### HOW JAPAN DEPENDS ON THE UNITED STATES

The new reliance on Japan may come as something of a shock to many Americans. If it's any consolation, the relationship goes both ways; Japan also needs us. Obviously, American weapons help protect Japan; U.S. exports as noted above figure prominently in the Japanese economy. According to the Economic Planning Agency of Japan, exports to Japan were about 18 percent of the country's economy during most of 1987.<sup>22</sup> The Ministry of Finance figures that the United States received about 37 percent of Japanese exports during the same period.<sup>23</sup> Putting the two figures together, about 7 percent of Japanese output ended up in the United States. Losing even a fair chunk of that would be very harmful to the Japanese economy.

If anything, Japan values its imports from the United States even more than its exports. Japan relies on its trading partners for much of its food, industries and raw materials. Self-sufficiency in food production on a value basis, which was 78 percent in 1970, had dropped to 71 percent by 1985.<sup>24</sup> Much of the difference comes from the United States.

The United States has a large balance of trade deficit with Japan, reaching about \$50–60 billion in 1987, varying on the basis of which set of figures one uses. If dependence is measured by imports, this figure seriously understates Japanese dependence. What Japan imports from the United States might be replaced with other foreign suppliers, but would be hard pressed to produce the products domestically. While Japan produces little wheat or soybeans, for example, and almost no petroleum, all three are of vital importance to the economy. By comparison, U.S. imports from Japan often have domestically produced substitutes.

In short, the products imported by Japan and the United States are a little like water and diamonds, to repeat an analogy famous in the history of economics. Japan buys something

<sup>20</sup>*Ibid.*

<sup>21</sup>MacKnight, 1987.

<sup>22</sup>Economic Planning Agency, unpublished data.

<sup>23</sup>*Toyo Keizai Geppo*, May 1988.

<sup>24</sup>"Japan, Agriculture, and the MTN," *JEI Report* no. 44A, November 20, 1987.



akin to water, which is abundant, cheap and absolutely necessary. It sells products to the United States which are more like diamonds—hard to produce, expensive and arguably unnecessary. If the monetary value of the “diamonds” exceeds that of the “water,” the resulting balance of payments surplus to the diamond producer tells us little about who is dependent on whom.

### WHERE DO WE GO FROM HERE?

By now it should be clear that the economic relationship between the United States and Japan is a complex one. Solving the problem is obviously not a simple matter of stopping the importation of a product that seems threatening.

First, it is obviously important that we think carefully about what we are doing. Otherwise we could shoot ourselves in the foot. Careful study of a proposal could help, if we are willing to believe the results. The voluntary export restraint on automobiles is an example of a trade action that, had policymakers heeded what the economists were telling them, could have prevented a lot of harm. This voluntary restraint sets a ceiling, broken down by Japanese manufacturer on the number of cars each can sell in the United States each year. It began in 1981 as a means of reducing competition with American makers and protecting American jobs. Economists predicted that it would lead to higher prices for both domestic and foreign cars, a small employment gain at a high cost for American automobile workers and diversion of the demand for Japanese cars to those from other foreign countries. They added that it would pale in importance compared to macroeconomic changes such as exchange rate movements and rates of economic growth.

Now, seven years later, with the Korean-made Hyundai the leading import in this country, the economists have proven correct. Only in 1987, two years after the yen began a sustained rise, did Japanese makers export less than the quota amount, demonstrating the strength of macroeconomic, compared to microeconomic, forces. A new Organization for Economic Cooperation and Development (OECD) study puts the cost to consumers in the form of higher prices at between \$93,000 and \$250,000 per job saved, showing the high cost of job protection.<sup>25</sup> In short, the OECD concludes that the voluntary restraint has achieved only some of its objectives, and those have been expensive.

Second, we need to learn from the Japanese. That means speaking and reading the language, so we don't find ourselves not knowing what Japanese regulations are. Recently, U.S. firms hoping to compete in the multi-billion dollar Japanese processed foods industry waited months for a translation of new regulations, with the result that they had inadequate time to prepare a response before implementation. If we permit the Japanese government or industry to decide what we need to know by relying on them for translation, we will often end up disappointed and out-negotiated. This includes technical translation. With the increased flow of technology outbound from Japan, translation of technical publications is a means of assuring that we get our share at a fair price and in a timely fashion.

For U.S. government and industry, these suggestions, if implemented, will imply new job criteria. The Japanese language is so difficult that mastery of the language should be considered a significant accomplishment for hiring and promotion. Government agencies and firms will have to learn to accept the inevitable tradeoff that better language proficiency comes at the expense of other abilities.

<sup>25</sup>OECD, *The Cost of Restricting Imports: The Automobile Industry*, (Paris: OECD, 1988). It is summarized in the *OECD Observer*, February-March 1988, p. 4-7.

Third, we have to better understand where our interests really lie. Too often, American negotiators have demanded that Japanese makers increase the prices they sell to us. What firm would ask his supplier to raise his price? The era of the high yen gives a particularly current example of this phenomenon. The Japanese currency has more than doubled against the dollar in the past three years. In order to recover their costs and maintain their profits in yen, Japanese manufacturers would have to almost double their prices. On the other hand, if they face American competition, raising prices could result in a disastrous loss of market share. They have chosen to increase prices a little, but not double them. Americans might be expected to appreciate the price break they have gotten, but instead we have insisted that the Japanese jack up prices an amount corresponding to the increase in the yen's value. In some cases, such a request amounts to asking that Japanese manufacturers collude; one Japanese firm considering raising prices by itself would be very reluctant once it realized that it would lose market share, and probably profits to Americans and other Japanese firms.

Fourth, we have to pick our fights more carefully. For one thing, as noted with semiconductors, automobile VERs and the recent controversy over pricing in the era of the high yen, doing nothing would have been preferable. In other situations, we have spent years arguing over products whose annual trade amounts to a relative pittance. Even if we are right, it's debatable whether argument has been worth the effort. This leads to a final suggestion—discussing a free trade agreement with Japan, perhaps modeled after the one negotiated with Canada in late 1987. This should, once ratified, substantially reduce the barriers to trade between the two countries.

Negotiating an agreement with Japan will be difficult, taking years to achieve. By the time an accord is reached, interdependence between our two countries is likely to be even greater. The ability to shoot ourselves in the foot will be even greater. We need to start thinking about it now.

## SUMMARY

Four years ago, Walter Mondale spoke of a future in which Americans would soon be reduced to sweeping up around Japanese computers. At the time, the metaphor seemed clear enough, but not so now. The Japanese computer might be made in the United States, the American one in Japan. The firm using it might be a Japanese-transplant firm employing American workers. The computer, whether American or Japanese, may use American software and Japanese chips. Yet politicians continue to use the same imagery of war, winners and losers. The interdependence between the two countries is evidence that each market participant, whether a firm or private consumer, sees something to gain and acts upon that perception. If we nurture rather than attack the relationship, those perceptions can become realities, and we can all be winners.



# SELF-DEFENSE AND THE EAST-WEST RIVALRY IN THE THIRD WORLD

Rodney C. Warren\*

The establishment of large nuclear arsenals by the United States and the Soviet Union since 1945 has instilled a sense of apprehension in both states about the outcome of a direct military confrontation between them. Threatened with the possibility of complete annihilation, the superpowers have made concerted efforts to abstain from the use of force in their bilateral relations with one another. Beyond the direct U.S.-Soviet relationship, these efforts have proven most successful in the industrialized states of Europe and the Far East. U.S.-Soviet relations have remained stable in these areas over the past four decades primarily because Washington and Moscow have committed themselves to using nuclear force to protect their vital global security interests. This commitment has produced a system of stable security alignments between each superpower and its industrialized allies; in effect, this makes the outbreak of war among any of these states entirely too dangerous to risk.<sup>1</sup>

Discouraged by the prospects for changing the status quo in the industrialized world, American and Soviet strategists have adopted a substantially different approach to the East-West rivalry in the non-aligned states of the Third World. Soviet Affairs specialist Alvin Z. Rubenstein believes that the fragile security alliances which exist in these states are primarily responsible for the relatively low-cost, low-risk policies adopted by the superpowers. He discusses how the nature of these alliances affects U.S. and Soviet foreign policy in *Soviet Foreign Policy Since World War II: Imperial and Global*. Rubenstein writes:

Whereas Europe and the Far East have relatively stable political and military constellations that coincide with established territorial boundaries and spheres of influence shielded by security agreements, Southern Asia, the Middle East, and sub-Saharan Africa\*\* are characterized by transient alliances and systematic instability and so have attracted superpower attention and rivalry. Gains or setbacks in these areas of contention are not likely to have a significant effect on the fundamental balance of power in the short run.<sup>2</sup>

Thus, the opportunity to manipulate the regional balance of power in those areas which are of marginal importance to the overall global balance has encouraged the superpowers to exercise fewer restrictions on their conventional use of force in the Third World. On those occasions when they do resort to force, the Americans and the Soviets consistently maintain that they are doing so for defensive purposes only. Consequently, this paper will analyze the contemporary doctrine of self-defense as it relates to the superpower use of force in the non-aligned states.

The right of self-defense in international law has traditionally been categorized as one component of the larger self-help doctrine. In this context, the defensive use of force can be interpreted as one type of sanction available to the individual state whose interests have been violated by the delictual conduct of another state.<sup>3</sup> According to D.W. Bowett, it is the precondition of international delinquency on the part of the state against which force is directed

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\*\*Due to recent events in Central America, this area should be included as well.

<sup>1</sup>Quincy Wright, "A Study of War", (Chicago: The University of Chicago Press, 1964), p. 429.

<sup>2</sup>Alvin Z. Rubenstein, "Soviet Foreign Policy Since World War II: Imperial and Global", (Boston: Little, Brown and Company, Inc., 1981), p. 214.

<sup>3</sup>Han Kelsen, "Principals of International Law", (New York: Holt, Rinehart and Winston, Inc., 1966), p. 13.

that comprises the heart of the self-defense concept. "The essence of self-defense," Bowett states, "is a wrong done, a breach of a legal duty owed to the state acting in self-defense . . . . The breach of duty violates a substantive right, for example, the right of territorial integrity, and gives rise to the right of self-defense."<sup>4</sup> This stipulation is also a pre-requisite for most of the other uses of force that have historically been included in the self-help doctrine. The most common examples of these are reprisals, intervention, and those actions taken to compel another state to submit a dispute to an international body, such as the International Court of Justice, for judicial settlement. In the latter case, if a decision has already been rendered, self-help can also be applied to enforce the terms of the international body's decision.<sup>5</sup>

Though all of these various forms of self-help are considered to be responses to an international delict, self-defense can be distinguished further by its intent. Its purpose is "to protect essential rights from irreparable harm in circumstances in which alternative methods of protection are unavailable; its function is to preserve the status quo."<sup>6</sup> This objective is in marked contrast to the purposes of the other forms of self-help which seek to impose more remedial or repressive measures on the delinquent state.

Another form of self-help which recognizes the individual state's right to use force is the extra-legal concept of self-preservation. However, unlike the previous forms of self-help already discussed, self-preservation is not dependent upon a prior violation of the law. It is a practice, predominantly based on moral considerations, that enables a state to suspend all norms of international law when its very existence is being threatened.<sup>7</sup> This unlimited ability to disregard all constraints on the use of force, if such action is deemed necessary for the survival of the state, provides the most significant distinction between self-preservation and self-defense. More importantly, since the "right" of self-preservation cannot be defined in purely legal terms, the trend in modern international law has been to recognize it as an instinctive right of every state, but not as a legal doctrine. If it were allowed to exist as a legal right, every state would be forced to "admit, suffer and endure every violation done to one another in self-preservation."<sup>8</sup>

Theoretically, self-defense can be easily distinguished from the other uses of force most commonly associated with the self-help doctrine on the basis of its limited objective. It is designed to protect territory or values currently held as opposed to destroying the values or territory of the delinquent state.<sup>9</sup> As a legal concept, it can be separated from self-preservation because it does not subordinate the law to moral principals. Yet, the function and scope of self-defense vis-a-vis the other uses of force is largely dependent upon the nature of the legal system in which it operates. In a decentralized system, where the authority to apply the law is delegated to the individual members of the community, each member is recognized as the sole judge of determining when its interests have been violated and how it will respond. Since there is no central organ capable of regulating the use of force under these conditions, self-defense is perceived as a basic, fundamental right of every state. As

<sup>4</sup>D. W. Bowett, "Self-Defense in International Law", (Manchester: The University Press, 1958), p. 9.

<sup>5</sup>Ibid. pp. 11-19

<sup>6</sup>Schwarzenberger, "Manual of International Law", 3rd ed.

<sup>7</sup>Kelsen, "Principals of International Law", p. 59.

<sup>8</sup>Hersh Lauterpacht ed., "International Law by L. Oppenheim", (New York: David McKay Company, Inc., 1965), p. 297.

<sup>9</sup>Myres S. McDougal and Florentino, "Law and Minimum Public World Order", (New Haven: Yale University Press, 1961), p. 218.



the system matures and the authority to use force is transferred to a central organ, given the responsibility of protecting its individual members' rights against violations, self-defense becomes an exceptional right, subject to review by the collective organs of the community.<sup>10</sup>

The absence of a centralized force monopoly in the international community before the twentieth century resulted in a highly decentralized system of law which recognized self-help as the principal means of protecting state interests. This virtually unlimited right of self-help, combined with the right to use war as an instrument of foreign policy, created a number of problems for interpreting self-defense. Bowett provides an excellent example of the complexities involved in distinguishing self-defense from the other uses of force by discussing the relationship of this right to the legitimate right of war. He observes: "The paradox of the positionist doctrine was that any state, by its own election to treat a 'pacific' use of force in self-defense as an act of war bringing about war *de jure*, could transform the legal privilege of self-defense into conduct legally indistinguishable from its own."<sup>11</sup> Yet, amidst the considerable amount of ambiguity that existed, a number of principals emerged which established the foundation for the contemporary self-defense doctrine.

One of the most important contributions to the modern definition of self-defense was made by the natural law proponent and theologian St. Thomas Aquinas. Aquinas was the first writer to explicitly stipulate that the right of self-defense is only legitimate when the state it is directed against bears the burden of fault.<sup>12</sup> This stipulation has become the most essential element for the defensive use of force today. Another important requirement which has evolved through customary state practice is the doctrine of proportionality. This doctrine confines the response of the state acting in self-defense to those measures that are necessary for the protection of its sovereignty.<sup>13</sup> The practice of proportional response has been adopted by states to ensure that the actions taken in self defense do not exceed what is necessary to protect those substantive rights that are threatened. In addition to these two basic guidelines, the *Caroline Case* of 1837<sup>14</sup> established the first specific criteria for determining when a state could resort to force in self-defense. The legal issue involved in the case dealt with the question of whether or not the British government was exercising a legitimate right when it seized the steamer *Caroline* and set it adrift over Niagara Falls. The British claimed that since the *Caroline* was being used by a small band of Americans to transport men and weapons from the U.S. into Canada during a time of rebellion—without any effort on the part of the U.S. government to prevent such action—they were acting within their right of self-defense. In response to the British government's claim, U.S. Secretary of State Daniel Webster established the requirements that have become mandatory for the exercise of self-defense under the present system of law. Webster argued that the right of self-defense was legitimate only when there was a "necessity for self-defense, instant and overwhelming, leaving no choice of means and no moment for deliberation."<sup>15</sup> He went on to reaffirm the doctrine of proportionality by stating that the act itself must consist of "nothing unreasonable, or excessive, since the act justified by the necessity of self-defense must be limited by that necessity and kept clearly within it."<sup>16</sup>

<sup>10</sup>Bowett, "Self-Defense in International Law", pp. 3-4.

<sup>11</sup>*Ibid.* p. 118.

<sup>12</sup>De la Briere, "Le Droit de Guerre Juste", (Paris, 1938), p. 32.

<sup>13</sup>*Ibid.* pp. 269-70.

<sup>14</sup>James Leslie Brierly, "The Law of Nations", (New York: Oxford University Press, 1963), p. 405.

<sup>15</sup>*Ibid.* p. 406.

<sup>16</sup>*Ibid.* p. 406.

The first substantive achievement of the twentieth century that helped to place these principals in the proper context was the signing of the Kellogg-Briand Pact in 1928.<sup>17</sup> The Treaty itself did nothing to restrict the customary right of self-defense. In fact, U.S. Secretary of State Frank B. Kellogg made it undoubtedly clear that no treaty could impair the individual state's right to defend its territory against attack or invasion.<sup>18</sup> However, by condemning the use of war as an instrument of foreign policy, the Kellogg-Briand Pact eliminated one of the most problematical uses of force that has previously been allotted to the members of the international community.<sup>19</sup>

Unfortunately, the restrictive use of the term "war" limited the overall effectiveness of the Treaty. For example, within four years of the signing of the Pact, there were at least three instances in which the use of force by an individual state could have been viewed as contrary to the spirit of Kellogg-Briand. These were the outbreak of hostilities without a declaration of war in 1929 between Russia and China over the Chinese Eastern Railway, the Japanese occupation of Manchuria in 1931 and Peru's invasion of the Columbian province of Leticia in 1932. Yet, because the Treaty did not include those uses of force that fell short of an actual declaration of war, the states involved could legitimately claim that they had not violated their obligations.

When the United Nations Charter was written in 1945, its authors enhanced the principals of the Kellogg-Briand Pact by using the all-inclusive term "the use of force" to outlaw the commission of any offensive acts by the state. Article 2, paragraph 4 of the Charter requires all members to "refrain in their international relations from the threat or use of force against the territorial integrity or political independence of any state, or in any other manner inconsistent with the Purposes of the United Nations."<sup>20</sup> The Charter accomplished an additional goal in regulating the use of force by creating a central organ, known as the Security Council, that was given the primary responsibility for maintaining international peace and security. These two achievements have succeeded in eliminating many forms of self-help that had previously been available to the state.<sup>21</sup> In fact, the only form of self-help that continues to maintain legitimacy under the present system of law is the right of self-defense.

The exclusion of self-defense from the prohibitions of Article 2, paragraph 4 can be found in Article 51 of the Charter which declares:

Nothing in the present Charter shall impair the inherent right of individual or collective self-defense if an armed attack occurs against a Member of the United Nations, until the Security Council has taken measures necessary to maintain international peace and security. Measures taken by Members in the exercise of this right of self-defense shall be immediately reported to the Security Council and shall not in any way affect the authority and responsibility of the Security Council under the present Charter to take at any time such action as it deems necessary in order to maintain or restore international peace and security.<sup>22</sup>

Though this article does not deny the right of self-defense, the impact of the Charter upon the use of force can be illustrated once again by the Security Council's authority to review

<sup>17</sup>Burns H. Weston, Richard A. Falk and Anthony A. D'Amato ed., "Basic Documents in International Law and World Order", (St. Paul: West Publishing Company, 1980), p. 93.

<sup>18</sup>Julius Stone, "Aggression and World Order" (Berkeley: University of California Press, 1958), p. 32.

<sup>19</sup>Ante, p. 5.

<sup>20</sup>Weston, Falk and D'Amato, "Basic Documents in International Law and World Order", p. 8.

<sup>21</sup>Bowett, "Self-Defense in International Law", pp. 11-19. Also see Pinkard, "Self-Help, Self-Defense, and Self-Preservation in International Law", Towson State Journal of International Affairs, Vol. xx, No. 2, (1966) pp. 63-76.

<sup>22</sup>Ibid, p. 14.



and respond to any defensive actions that may be taken by a state. This stipulation has transformed self-defense from a basic, fundamental right into an exceptional right open to review by the collective organ of the community.

If American and Soviet actions in the non-aligned states are to be interpreted as defensive uses of force, they must conform to the principals embodied in Article 2, paragraph 4 and Article 51 of the U.N. Charter. Not surprisingly, both sides argue that they are acting in accordance with the Charter because their rights are being threatened by the ideological differences which separate East from West. Since ideology has become the primary justification for the superpowers' use of force in the Third World, any analysis of the legality of these acts should begin with the origins of the Cold War. Unfortunately, there is no definitive theory as to how the Cold War began. As a result, a number of contending hypotheses have emerged.<sup>23</sup>

The oldest hypothesis dates from the nineteenth century and the writings of Alexis de Tocqueville, who as early as 1835 predicted that the U.S. and the U.S.S.R. would become natural enemies. De Tocqueville based this prediction on his assessment of the two states' potential for becoming great powers. He believed that the benefits of possessing a large territory and an abundance of natural resources would give the American and Russian people so much power that each would eventually "hold in its hands the destinies of half of mankind."<sup>24</sup> Once this status was reached, the two powers would instinctively adopt those classical patterns of behavior which have dictated all great power relations throughout history—that is, each state would view actions taken by the other as an attempt to tilt the balance of power against it. By interpreting events in this manner, the two states would find themselves entangled in an unending series of confrontations over divergent national interests.

The second hypothesis suggests that while the American-Soviet rivalry was not inevitable, it became an unavoidable consequence of the communist takeover in Russia. Proponents of this thesis argue that the capitalist and communist systems are so diametrically opposed that they will never exist in harmony. For this reason, they claim that relations between the United States and the Soviet Union have always been tense and will continue to be so in the future. According to Charles W. Kegley and Eugene R. Wittkopf, if the Cold War is viewed in this context, it is merely "an extension of the suspicions, distrust, and repugnance that the two states traditionally have felt for each other's professed way of life."<sup>25</sup>

The final view maintains that the Cold War was a product of the events which took place immediately following World War II. These analysts believe that there was a genuine spirit of cooperation between Washington and Moscow during the war. However, once the Axis powers were defeated, the cordial wartime alliance rapidly disintegrated. One group claims that this breakdown in relations was the result of President Roosevelt's death, because his successor Harry Truman adopted an openly belligerent posture towards the Soviet Union, thereby destroying any hope for American-Soviet cooperation in the post-war era. The other group attributes the breakdown to misunderstanding on both sides about the intentions of the other. George F. Kennan, an authority on Soviet-American relations, and U.S. Ambassador in Moscow during the early years of the Cold War, has given many examples of this. He writes:

<sup>23</sup>Charles W. Kegley Jr. and Eugene R. Wittkopf, "American Foreign Policy: Pattern and Process" (New York: St. Martin's Press, 1982) pp. 50–56.

<sup>24</sup>Ibid, p. 50.

<sup>25</sup>Ibid, p. 50.

The Marshall Plan, preparations for the setting up of a West German government, and the first moves toward the establishment of NATO were taken in Moscow as the beginnings of a campaign to deprive the Soviet Union of the fruits of its victory over Germany. The Soviet crackdown in Czechoslovakia (1948) and the mounting of the Berlin blockade, both essentially defensive . . . reactions to these Western moves, were then misread on the Western side. Shortly thereafter, there came the crisis of military force in civil combat to its own advantage, by way of reaction to the American decision to establish a permanent military presence in Japan, was read in Washington as the beginning of the final Soviet push for world conquest; whereas the active American military response provoked by this move, appeared in Moscow . . . as a threat to the Soviet position in both Manchuria and in eastern Siberia.<sup>26</sup>

The hypothetical origins of the Cold War seemed relatively unimportant by 1947, because the animosities which existed on both sides of the East-West rivalry had become so deeply embedded that conciliation was considered to be virtually impossible. Under these conditions, each superpower began to develop long-term strategies for protecting its global interests from the "expansionist" or "imperialist" activities of the other.

The American approach to protecting its interests against the communist threat was founded in Kennan's analysis of the Soviet leadership and its objectives.<sup>27</sup> His concern with Soviet postwar intentions was highlighted by Stalin's speech of February 1946, in which the Soviet Secretary urged the people to maintain their revolutionary zeal in preparation for the inevitable conflict between the communist and capitalist states. A few months after this speech, Kennan sent his famous "long-telegram" to Washington warning U.S. officials of the potential dangers of Soviet foreign policy. The telegram referred to communism as:

. . . a political force committed fanatically to the belief that with (the) U.S. there can be no permanent *modus vivendi*; that it is desirable and necessary that the internal harmony of our society be disrupted, our traditional way of life be destroyed, the international authority of our state be broken, if Soviet power is to be secure.<sup>28</sup>

This evaluation of Soviet global objectives was also the basis for Kennan's equally famous "X" article published by "Foreign Affairs" in 1947. Entitled "The Sources of Soviet Conduct," the article surmised that Soviet leaders would never feel secure in their political power because they were unsure of their ability to protect it against domestic and foreign threats. Their insecurity would in turn lead to the adoption of an anti-American policy that could possibly become hostile. He concluded that the seriousness of the threat should impress U.S. officials with the immediate need to diffuse this potentially harmful situation by forcing the Soviet leadership to tone down, and hopefully abandon, its vehement anti-American stance.<sup>29</sup> In putting forth his opinion as to how this goal could be achieved, Kennan created a theory that became the cornerstone of American foreign policy vis-a-vis the Soviet Union. His proposal was "a long-term, patient but firm and vigilant containment of Russian expansive tendencies."<sup>30</sup>

The containment policy received a great amount of notoriety in Washington and quickly became the official U.S. policy—although somewhat altered from Kennan's original intentions.<sup>31</sup> Communism was defined as an expansionist force that had to be contained since

<sup>26</sup>George F. Kenan, "The United States and the Soviet Union, 1917-1976", *Foreign Affairs* 54 (July, 1977) pp. 683-684.

<sup>27</sup>*Ibid.*, p. 59.

<sup>28</sup>*Ibid.*, p. 59.

<sup>29</sup>Kennan ("X"), "The Sources of Soviet Conduct", *Foreign Affairs* 25 (July, 1947), pp. 566-582.

<sup>30</sup>*Ibid.*

<sup>31</sup>Kennan, "Memoirs", (Boston: Little, Brown, 1967), p. 361.



it was committed to the destruction of American international prestige. Consequently, the Truman Doctrine was established as a means of protecting U.S. global interests from the dangers of international communism. The Doctrine proclaimed: "The free peoples of the world look to us for support in maintaining their freedoms. If we falter in our leadership, we may endanger the peace of the world—and we shall surely endanger the welfare of our nation."<sup>32</sup> The purpose of President Truman's declaration was to inform Moscow that the U.S. was prepared to take any steps necessary, be they political, economic or military, to support non-communist governments throughout the world.<sup>33</sup> The most significant result of this doctrine was the creation of the Marshall Plan in 1947, which provided the Western European democracies with an all-encompassing economic program to facilitate the reconstruction of their war-ravaged countries.

The Soviet leadership interpreted the containment policy as a threat to its own strategic interests. Thus, in retaliation for U.S. actions, Stalin established a closed ideological and political system that made the separation between the wartime allies complete.<sup>34</sup> The justifications for the creation of this system were explained by one of the leading members of the Politburo, Andrei Zhdanov, at the inaugural meeting of the Cominform (Communist Information Bureau) in September of 1947. While discussing the "New Aspects of World Conflict" since the Second World War, Zhdanov claimed that the world had been divided into two hostile camps. One camp consisted of the "freedom-loving democracies" led by the Soviet Union, and the other camp was composed of the "imperialistic war mongers" and "capitalist aggressors" led by the United States. He concluded that the latter camp wanted to create another imperialist war to defeat the cause of socialism, and was willing to support any anti-democratic force in pursuit of this objective.<sup>35</sup> Therefore, it was the duty of all communists to "head the resistance to the plans of imperialist expansion and aggression along every line—state, economic and ideological."<sup>36</sup>

The preoccupation of the superpowers with events in Europe was extremely evident during the early stages of the Cold War, as each side attempted to establish its dominance in those areas which were considered vital to its own security needs. After the initial period of adjustment, both the Americans and the Soviets realized that they would face a serious and possibly fatal challenge from their adversary if either one of them attempted to alter the balance of power that had been created by the division of Eastern and Western Europe. This harsh reality forced officials from both states to devise alternative methods by which they could continue the search for increased global influence. The newly emerging states in Africa, Asia and the Middle East gave them an opportunity to do just that.

The increased interest of the Soviet Union in the non-aligned states was precipitated by two major foreign policy concerns.<sup>37</sup> First and foremost, the Kremlin wanted to continue its policy of unrelenting hostility toward Western initiatives. Yet Moscow was reluctant to explore the potentially dangerous consequences posed by a direct confrontation with the U.S. in Europe. Robert C. Horn discusses this predicament, and how the Soviet leadership dealt with it in *Soviet-Indian Relations: Issues and Influence*. He observes:

<sup>32</sup>Kegley Jr. and Wittkopf, "American Foreign Policy: Pattern and Process", p. 41.

<sup>33</sup>Ibid.

<sup>34</sup>Rubenstein, "Soviet Foreign Policy Since World War II: Imperial and Global", p. 51.

<sup>35</sup>Andrei Zhdanov, "The International Situation", (Moscow: Foreign Language Publishing House, 1947), excerpts.

<sup>36</sup>Ibid.

<sup>37</sup>Robert C. Horn, "Soviet-Indian Relations: Issues and Influence", (New York: Praeger Publishers, 1982), p. 3.

The emergence of large quantities of nuclear weapons had encouraged, in the post-Stalin Soviet leadership, an appreciation of the very real danger of East-West confrontations having catastrophic results. The area of greatest potential explosiveness was naturally Europe where already tensions were high and the situation was stalemated. However, while the status quo should and could be maintained there, Soviet leaders sought other areas where the struggle or competition . . . could be waged. It was in the Third World, Krushchev and others enthusiastically and optimistically believed, where the West seemed particularly vulnerable.<sup>38</sup>

The second foreign policy objective of the Soviet Union dealt with the purely strategic concern of extending the Soviet presence to those areas of the world that had heretofore been beyond the political and economic capabilities of the state.

In an effort to achieve these goals, Krushchev denounced the Zhadanov line of supporting foreign communist parties in the non-aligned states which were attempting to overthrow the new nationalist bourgeois governments. This policy had proven to be counter-productive over the past decade because foreign communist parties were being eliminated from the mainstream of political activity in their own countries. Therefore, the Zhadanov line was replaced by a number of far-reaching economic and military assistance programs aimed at destabilizing both the system of Western-oriented military alliances and the entire international economic system—which was believed to be designed to favor the industrialized economies of the West.

The basis of Moscow's new approach was "peaceful coexistence." This new policy was announced by Krushchev himself at the Twentieth Congress of the Communist Party of the Soviet Union, and was intended to signal the Third World that the Soviets were willing to cooperate with different social and political systems for the purpose of promoting democracy. He suggested that the two forces should abandon their antagonisms and work together in what he called a "zone of peace." The Soviet leader emphasized his apparent sincerity by promising that his government would make a concentrated effort to establish an atmosphere of friendship and cooperation with those states "which stand for peace, refuse to be involved in military pacts, and seek to preserve peace."<sup>39</sup>

Officials in Washington recognized that their Third World interests could be threatened by Moscow's "forward" policy. Thus, they began to re-evaluate an outdated U.S. policy to respond to this new international development. Although American involvement in the non-aligned states began with the dissolution of the European colonial empires, Washington had underestimated the strong feelings of nationalism that these newly emerging states possessed. It perceived the non-aligned states exclusively as an additional bulwark against communist expansion, and showed little concern for those problems which were particular to the Third World. This policy led to the alienation of many influential leaders of the non-aligned movement, such as President Nasser of Egypt and Prime Minister Nehru of India, for their refusals to choose sides in the Cold War.<sup>40</sup>

Once the Soviets implemented their new policy, U.S. officials were forced to admit that they had misjudged the purpose of non-alignment—a miscalculation which cost them a great deal of credibility in the Third World. By the mid-50's, the Americans came to realize that their condemnation of non-alignment for its neutralist philosophy was driving the Third World states closer to the Soviet Union. It was at this point that the U.S. began to develop a different strategy for waging the Cold War in the non-aligned states. President Kennedy set

<sup>38</sup>Ibid, p. 4.

<sup>39</sup>N. S. Krushchev, "Report to the Central Committee of the Communist Party of the Soviet Union to the 20th Party Congress", *Pravda*, February 15, 1956.

<sup>40</sup>Selig S. Harrison, "India, Pakistan and the U.S.: Cost of a Mistake", *New Republic*, August 10, 1959, p. 13.



the tone for this new policy in the early 60's, when he established the Alliance for Progress to promote social and economic advancement in the less-developed states of the Western hemisphere. America's new policy was also reflected in Kennedy's attempts to bring about closer relations with India, to replace the animosity that existed between the two states with a genuine atmosphere of friendship and cooperation.

The expansion of the Cold War into the Third World signifies a desire by both Washington and Moscow to link their own security needs with the entire global balance of power. In pursuit of this comprehensive global strategy, the superpowers have adopted the same justifications for the use or threat of force in the non-aligned states that had previously been used to polarize Eastern and Western Europe.<sup>41</sup> Future developments may prove that there was a legitimate cause for either one or both of the superpowers to take defensive measures in the Third World, however, most of the evidence up to this point would seem to indicate that American and Soviet actions in these states are contrary to the contemporary self-defense doctrine.

One of the first arguments raised against superpower involvement in the Third World is the fact that international law has not yet established a correlation between self-defense and the Cold War. Therefore, critics maintain there can be no legal right of self-defense until the subversive activities undertaken in this type of warfare are classified as delicts. This position is evident in Bowett's statement that "the right of self-defense in relation to these new techniques (of ideological warfare) will only have a juridical connotation when their use can be characterized as delictual."<sup>42</sup> In the meantime, any use of force by the United States or the Soviet Union on the basis of ideology alone should be interpreted as an exercise in self-preservation, and not self-defense.

The fact that states are presently denied the right of self-defense in a case of ideological warfare does not mean that this type of conflict is harmless. On the contrary, the same critics who would argue against the defensive use of force as a response to subversive activities based on ideology would also agree that these activities constitute a very real threat to the continuation of state sovereignty.<sup>43</sup> The problem is that these new techniques represent a development in international relations which our contemporary legal system has not come to terms with. Keeping these realities in mind, it would seem reasonably safe to assume that self-defense will eventually incorporate the use of force in response to certain types of ideological warfare. When this happens, American and Soviet actions will have to be examined more carefully. Even so, debate will continue over the legality of the superpowers' actions in the non-aligned states because Third World events do not, as a general rule, pose a threat to the substantive rights which have traditionally been protected by self-defense. These rights include the defense of territorial integrity, political independence, certain economic interests and the protection of nationals.<sup>44</sup>

The most important issue for this analysis of United States—Soviet relations is the right of political independence. In part, this right involves a state's freedom to "... maintain diplomatic intercourse with other members of the international community."<sup>45</sup> Thus, to justify

<sup>41</sup> Ante, pp. 11–14.

<sup>42</sup> Bowett, "Self-Defense in International Law", p. 271.

<sup>43</sup> Ibid., p. 271. Also See Julius Stone, "Legal Control of International Conflict", (New York: Rinehart and Company Inc., 1959), p. 318–32.

<sup>44</sup> Bowett, "Self-Defense in International Law", pp. 29–114.

<sup>45</sup> Hersey, "Essentials of Public International Law", 1912, p. 147.

the use of force in self-defense, each superpower argues that military intervention by its ideological adversary poses a direct threat to its own ability to establish and maintain friendly diplomatic relations with certain non-aligned states. The White House bases its argument on the conviction that communism is dedicated to the destruction of American international prestige. It supports this belief by blaming the unfriendly relations which exist between the United States and states like Cuba, Nicaragua and Angola on Soviet military support for the governments presently in power. The Soviets, on the other hand, view the United States' actions as nothing more than an imperialist crusade to eliminate their influence in the Third World. They claim that as long as the United States gives military aid to oppressive governments in states like El Salvador, Chile and Zaire, the Soviet Union can never establish friendly relations with these states. In reality, however, both the American and Soviet arguments do not provide a clear explanation for the present state of relations between the superpowers and the non-aligned world.

One extremely critical fact the superpowers attempt to downplay when explaining their use of force in the Third World is that the non-aligned states have developed different interests and priorities apart from the Cold War.<sup>46</sup> The members of the Third World have been placed in the unique position of participating in a system of international relations that was established without their consent. In fact, many of the non-aligned states were exploited colonies of the European powers when the foundation was laid for the contemporary system of inter-state relations. Consequently, the newest members of the international community are more concerned with becoming equal participants in world affairs, as opposed to choosing sides in an ideological conflict which does not directly concern them. The most illustrative example of this point is the on-going North-South dialogue.

These negotiations between the industrialized, economically affluent states of the world's northern hemisphere and the less-developed, impoverished states primarily located in the south, revolve around the central question of how the latter can gain more economic independence. The non-aligned states claim that the present international economic order has numerous structural inequities which inhibit their growth. In an attempt to rectify the situation, they have proposed the creation of a New International Economic Order that would transfer some of the world's wealth to their poor states.<sup>47</sup> However, as members of the industrialized world, the superpowers have been reluctant to alter the present international economic system because it favors their advanced economies. Thus, the United States and the Soviet Union have created a major division between themselves and the Third World which has nothing to do with the ideological struggle between East and West.

The refusal of the non-aligned states to become involved in East-West issues has discredited the entire foundation of American and Soviet foreign policy in the Third World. Since the non-aligned states have begun to independently pursue their own objectives, the superpowers cannot justify their use of force in the Third World on the basis of the Cold War. This does not mean that instances never arise in which the superpowers would be justified in resorting to force in self-defense. For example, the United States had a legitimate right to attempt to use force to free the hostages that were taken by Iranian revolutionaries in 1979. However, if the American and Soviet use of force in the non-aligned states is to be interpreted favorably, it must be in response to a specific situation, and not a reaction based on Cold War ideology.

<sup>46</sup>Kegley Jr. and Wittkopf, "American Foreign Policy: Pattern and Process", p. 160.

<sup>47</sup>Ibid, p. 160.