

## **“No More Bashing: Building a New Japan-US Economic Relationship”**

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**C. Fred Bergsten**

**Director, Institute for International Economics (IIE)**

Our new book is called *No More Bashing: Building a New Japan-United States Economic Partnership*. My question to you is: Do you like the title? Is it appropriate? Our view is that it is time change the nature of the US-Japan relationship, away from one based on pressure from the US. But, I ask, is Japan capable of reform without outside pressure?

The theme of our book is that for the past 30 years, Japan has been an anomaly in US economic policy. The US maintained a country-specific Japan policy. Since the Nixon shocks, the US focus toward Japan has changed shape: from the "locomotive theory" during the Carter Administration, to Reagan's market opening measures, to the Structural Impediments Initiative (SII) under Bush, to Clinton's Framework Talks, and finally the current Economic Partnership for Growth (EPG). The specific goals have changed; now the focus is more macroeconomic.

Our argument of Japan-as-an-anomaly is built on the following fundamental underpinnings:

1. Japan's economic size and dynamism were unique. Japan was by far the most dynamic economy. The perception was that Japan posed a real threat to US economic dominance and prosperity. Americans were, in fact, more fearful of Japan's economy than of the Soviets' nuclear weapons.
2. Japan had a unique economic system, which required a different response. Japan was seen as playing unfairly. Its government played a major, driving, central role.
3. The US had a unique capability to affect policy in Japan. The US's influence was related to the defense relationship. Moreover Japan relied on the US for its market and the US dollar.

As we further reflected on the US-Japan relationship, we noticed that timing came to be crucial. Just when the Japanese economy was booming was when the US economy was declining. For example, while average American wages were constant for 20 years, Japan was rising to prominence. We argue that this historical accident led to the particular policies of the time.

The point here is the following: the unique circumstances that gave rise to US policy toward Japan have disappeared:

1. The US economy bounced back strongly in the 1990s. Meanwhile we saw less bashing coming from the US. We had an average 5 to 6% growth in GDP. The US resurgence was led by the sectors that were supposedly threatened by Japan: hi-tech and information technology. The US was not doomed to become primarily a wheat exporter. (I see the US economy recovering by the middle of next year.)
2. Japan's economic performance reversed. This changed the underpinning of the US-Japan relationship. Also other economies (such as Europe and China) became more prominent while Japan's relative prominence fell. Separately, there was a change in the global institutions. With the advent of the WTO's dispute settlement mechanism, the US could not easily threaten Japan with aggressive unilateralism (the operative *gaiatsu* or foreign pressure). The role of the Japanese economy has fallen, as have American accusations of unfairness. An interesting thing to note here is that in the US, 50% of Americans are in favor of globalization and 50% are against it. But it appears that very little of the attack on globalization has to do with Japan; rather, the problems people have are with low wages and low standards in developing countries. Michael Porter of the Harvard Business School, in a study of Japan, concluded that in its success story, nothing was unique to Japan (such as culture, etc.). Rather Japan's success was due to innovative management techniques. In other words it could be replicated, as the US did.
3. The idea that the US can change policy in Japan has come under scrutiny. On the whole, negotiations between the US and Japan have not been very successful. They were really a series of spectacular failures.

The factors that drove the old relationship have disappeared. The US should now treat Japan like it treats other countries.

**Takatoshi Ito**

**Professor, Hitotsubashi University**

Ten years ago, Japan's strength was the threat, now it is its weakness. The Japanese economy is in a sorry state. Growth has been consistently below potential. Fiscal and monetary stimulus policies have not worked. The non-performing loan (NPL) problem is still an issue and deflation is accelerating. Here is my prescription for what ails the economy:

1. The Bank of Japan should embrace inflation targeting; the BOJ should aim to stop deflation, back up its commitment, and stabilize the economy.
2. Regarding government spending, Japan's debt-to-GDP ratio will be 140% by the end of the year; it is necessary to slowly reduce deficits. Meanwhile spending should shift to higher multiplier, urban public works areas.
3. As they are the biggest problem, the NPLs should be cleaned up. The Financial Services Agency (FSA) should make their bank examinations more stringent. Provisions should be made ready so that corporate failures will not threaten the banks' health and level of capital. The FSA should inject capital into the banks with dwindling capital and temporarily nationalize those that are insolvent. More deflation is in store; the BOJ must be ready to be more aggressive. Deregulation, especially in the housing sector, can also stimulate aggregate demand. Current zoning laws make no sense. If restrictions were relaxed, the Japanese could have larger houses and therefore have more room for consumer goods.

To avoid moral hazard, these policies should be placed in a single package—fiscal, monetary, and structural reform.

"No more basing" from a Japanese perspective means no more *gaiatsu*. It has been a waste for bureaucrats to engage in futile US-Japan bilateral talks. Policymakers should shift their focus towards domestic reform. There are sufficient multilateral institutions to handle conflicts.

**Marcus Noland**  
**Senior Fellow, IIE**

I would like to make four points and pose one question.

1. The differences between Japan's and other countries' economies, such as price distortions, have diminished.
2. Border impediments to trade have been eliminated. The issue now is deregulation, but it is largely a reallocation of rents within the economy. In civil aviation, for example, the rents have been transferred from producers to consumers. It is unlikely that the US will continue to play the role of a quasi opposition party in Japan.
3. As long as Japan relies on foreign pressure for reform, it should use multilateral forums such as the WTO. Antidumping could be addressed at the WTO. The OECD can handle competition policy. Financial regulations could be examined at the IMF.

4. The US is highly susceptible to special interests, so it is better to keep trade relations at the multilateral level.
5. The regional roles (such as being the providers of public goods) of both states should be taken into account.

Now here is my question. It has been said the "Koizumi Syndrome" is one of big announcements but little action. The war on terrorism could either be quick with universal condemnation of terror or long and protracted. If the crisis goes on for a longer period of time, would it require Koizumi to shift the use of his political capital away from economic issues?

### **Question & Answer**

**C.H. Kwan**

**Senior Fellow, RIETI**

The old US-Japan relationship is like the current Japan-China relationship. But Japan has little leverage with China. How would you advise the Japanese government to deal with China?

***Q: Will the US have no country-specific policies anymore? What about a China-specific policy?***

***Q: WTO schemes can deal with China's economic issues, but negotiations come at a price. Can we rely on the WTO?***

**Marcus Noland**

China may have been the only other country towards which the US had a country-specific policy. It was large and not in the WTO. Chinese membership in the WTO will make it easier for Japan. Take the Japan-China trade disputes this year:

Japan slapped tariffs on its tatami, shiitake, and onions. China retaliated by taxing Japanese imports of air conditioners, cars, and cell phones. From this episode we learned that Japan is still captive to its uninteresting agriculture industry and that China retaliates in a disproportionate manner. If China is in the WTO, it will constrain Japan's protectionism and if Japan does protect its industries China will be obliged to retaliate in a way that is proportionate. Moreover WTO negotiations are more structured than the open-ended bilateral type.

**C. Fred Bergsten**

The WTO has rules that will help Japan. One thing that surprised me about the story Dr. Noland recounted is that the Japanese government did not expect China to retaliate. I do not think that there will be a new US-China framework, especially if there is strong US growth. We have the WTO.

**Takatoshi Ito**

Having these sub cabinet meetings between the US and Japan invites the possibility that US special interests will creep up again.

**C. Fred Bergsten**

I am interested to know what the likelihood is of a Japan-China free trade agreement.

**C.H. Kwan**

After being at RIETI for several months now, I get no feeling whatsoever that the Japanese government would like to form an FTA with China. Such an agreement would mean that Japan would have to give up its declining industries, which it is not ready to do. Politics, not economics, are very much in play here.

**Marcus Noland**

I, too, am skeptical about these FTAs. Unless Japan deals with its agriculture sector, it won't go anywhere.

**Ichiro Araki**

**Director of Research, RIETI**

As *gaiatsu* fades, Japan's own agriculture lobby is becoming stronger. What can we do about its influence?

**Takatoshi Ito**

It is true that agriculture, especially rice, is captured. But a new *gaiatsu* would not help. Multilateral institutions are better.

**C. Fred Bergsten**

Concessions can be made during multilateral negotiations. During the Tokyo Round, for example, the US added an injury test to its countervailing duties mechanism. The issue now is antidumping; it could be addressed as part of a larger package. There has to be trade offs.

***Q: From your presentations, I hear a new mindset. But who will articulate it? The time is right, but is either side ready?***

**C. Fred Bergsten**

I would be surprised if all that we proposed was adopted. We are trying to push the envelope for both governments. But for the US, a lot of it is quite doable.

***Q: Does no more bashing include no more pressure on Japan to reevaluate the yen? People say that a steady current account deficit will lead to a currency crisis. But the US is forced to run a deficit because of the large capital inflow (capital account surplus). Why do you say in your book then that the US can only run a current account deficit for two more years?***

**C. Fred Bergsten**

We thought we were being upbeat when we said that US could carry the current account deficit for another two years. I see the dollar actually getting stronger in the short term.

**Takatoshi Ito**

Yes, no more bashing does mean no more pressure to reevaluate the yen.

***Q: There is no mention in your book of ideal exchange rate regimes.***

**C. Fred Bergsten**

There is no interest in moving to a stable exchange rate regime. Governments are committed to floating regimes.