

ECONOMIC DIPLOMACY WITH JAPAN

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ECONOMIC DIPLOMACY WITH JAPAN

THURSDAY, JUNE 18, 1992

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to notice, at 10:22 a.m., in room 2359, Rayburn House Office Building, Honorable Lee H. Hamilton (vice chairman of the Committee) presiding.

Present: Representative Hamilton and Senator Bingaman.

Also present: Lee Price and Charla Worsham, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

REPRESENTATIVE HAMILTON. The Joint Economic Committee will come to order.

Former Ambassador to Japan, Mike Mansfield, used to say that the relationship between our two countries was the most important bilateral relationship in the world.

With the demise of the Soviet Union, economic issues have become more important in international relations. With decades of growth much faster than here or in Europe, Japan has come to have an economy second only to our own in size and role in the world. In a growing number of industries, Japan has technology and products that match or surpass our own.

Japan's economic and technological success have made it a model for many other countries, thus managing an effective relationship with Japan is important not only because Japan is so important, but because it can set the tone for a relationship with Japan's many emulators.

We are pleased to have with us today three very knowledgeable witnesses to discuss economic diplomacy with Japan. Both James Fallows of *The Atlantic Monthly* and Edward Lincoln of the Brookings Institution have lived in Japan and written extensively on the Japanese economy. Due in no small part to their work, we have a better understanding of the Japanese economy than we did five years ago.

Michael Aho is Director of Economic Research at the Council on Foreign Relations in New York.

Gentlemen, we are very pleased to have you with us this morning. You each have statements. They will be submitted for the record in full. We will just ask you to summarize your testimony if you would.

I will ask Senator Bingaman if he has any statement to make.

SENATOR BINGAMAN. I do not, Mr. Chairman.

REPRESENTATIVE HAMILTON. All right, sir. We will proceed.

Mr. Fallows, why don't we begin with you and move across the table in this manner, and you may begin, sir.

STATEMENT OF JAMES FALLOWS, EDITOR,
ATLANTIC MONTHLY

MR. FALLOWS. Thank you very much, Mr. Chairman.

Senator Bingaman, thanks for having me here and giving me this chance. As you said, I have an extensive prepared statement, which I won't go through now.

I would like to talk very briefly about the two kinds of imbalance which I think are worth bearing in mind as we consider our position towards Japan and our position in the world. One of them, of course, is a matter of purely economic imbalance and the other is a sort of geopolitical imbalance between our ambitions in the world and our economic resources. These are connected, but I think there are separable points to consider them. In my prepared statement, I talk a lot about the nature of this economic imbalance.

I would like to mention now one conceptual point that I think deserves more attention than it may have had in our political debate in the last while, which is a failure of imagination, or of understanding, or of historical grasp in the United States.

It seems to me that in many ways, the United States is in the same intellectual position that Great Britain was in the early 20th century when we had risen to economic power by the end of World War II through a variety of means that were not mainly free trade-related.

As you well know, the growth of the American economy in the 18th and 19th centuries had very little to do with the theories of Adam Smith. There were a number of aggressive state tools to try to develop our national economy. When Britain had developed its economy by similar tools in the 17th and 18th centuries, it came to conclude in the 19th century that now was the time for "free competition with the rest of the world" when its industries had already achieved supremacy.

I think something similar happened to us at the end of World War II. When our industries had become the most powerful in the world, we said, "Okay, it is time for open competition with everyone else, let the best man win," confident at that time that we would win because our technology was superior.

The problem is that we came to believe this theory and this explanation too thoroughly. We came to misread our own economic history and of that most growing powers to think that the simple version of neo-classical economics that we all learned in school was, in fact, how the world worked, and the contrast I would like to make here is to the basic idea of economics that I think has been in the mind of Japan's leaders for the last 40 years, and perhaps for the last 100 years.

In their view, economics has not been a matter simply of maximizing consumer welfare or having the most perfect markets in the world, but of preserving national independence.

When Japan was brought into the world system forcibly in the 1850s and 1860s, its hope to avoid colonization was to have some kind of technological and economic capacity. After World War II, its hope for some kind of national independence was to build its economic system, and I think that concept of economics was more like ours in the 19th century and remains—there

is a gulf, a remaining gulf, I think, between that view of what an economy is for and our misreading of how we achieved our economic might.

I think many of the tensions, and I try to explain this more fully in my statement, that we have now with Japan come from this different theoretical view of how economies grew. We think we grew in a different way from the way we actually did. Japan may have a more realistic sense at the moment.

Let me mention one or two other brief aspects of this economic imbalance that I think are important. I think there are three questions the United States needs to resolve about the economic imbalance in determining its policy towards Japan. One question which has been more and more debated in the last few years is whether these two economies will naturally converge in their natures and their growth paths. That is, as the Japanese people become more rich, will they become "more lazy, more spendthrift," etc., more like us, to put it in simple terms.

My view is that will not naturally occur. We have been predicting this for many decades, and it hasn't yet occurred, but it is one of the important questions for us to deal with.

A more immediate question is whether the Japanese industrial miracle will be brought to a halt by Japan's current financial problems, whether the banking and stock market and land depressions in Japan will have a deeper effect on the real economy of Japan. My impression is that that will not be the case.

The real economy of Japan remains strong, despite the financial difficulties of the moment, but this is another thing for us to resolve.

A third issue for us to resolve about the economic imbalance is whether automatically, through the workings of multinational corporations and the invisible hand, economic development will proceed to our benefit, whether as companies invest around the world and products move across borders, we will naturally profit in this borderless age.

Most of the thrust of our economic theory says yes, that naturally this will benefit us and other people. There is an argument that can be made that we will not naturally benefit, that countries that want to develop industries more on their own will have more of them in the long run than countries that don't, but I won't say anything more about those at the moment.

Let me mention now the other imbalance—the other subject of imbalance that I think is important—which is the political and geo-strategic imbalance. The large dimensions of this are fairly obvious, I think. The United States has, since World War II, been optimized or maximized for world political and military leadership.

It has taken for granted the economic base with which to carry that out, and as we saw most dramatically during the Gulf War that is no longer the case. We had to ask our allies for money to carry out commitments we wanted to make. We thought these requests were fair, but from the rest of the world's perspective, they looked weak, they looked humiliating, they looked like a beggarly thing to do, and I think the Rio Summit illustrates again what we are constrained from doing when we don't have enough money.

Japan has the opposite problem. It has the money to carry out many of these efforts, but not the political experience or the confidence to do so.

I wanted to make one point about this imbalance that I think is not often developed in the American debate, which is why it is that Japan has this hesitancy about matching its economic might with its political confidence. This is often ascribed to some innate trait of the Japanese people, their insular nation, etc. Maybe that matters, maybe it doesn't.

I think there is a much more specific historical route in the occupation era when, for reasons I won't go into at the moment, Japan had a debate during about the first ten years after World War II about whether or not it should be "a normal country." Normal in the sense of having a full military presence in the world, a full diplomatic presence in the world, and it decided under U.S. pressure essentially that it would not be a normal country, that it would delegate those normal functions to the United States and would concentrate only on economic expansion.

The result of that has been a system that is optimized for economic expansion, but not for other things, not for diplomatic interaction with the world, and not for a sense of confidence about controlling with its own institutions its foreign policy.

I think a lack of faith in Japan about controlling the Japanese military is one of the important things that keeps Japan from having a more normal role, like the one Germany now has. So, without belaboring the point now, each country needs to redress its side of the imbalance. The United States needs to find ways to have more money to back up the things it wants to do or else to want to do less and Japan needs one way or another to be brought into a more normal role in the world. I think Germany is the main example.

That is all I will say at the moment.

[The prepared statement of Mr. Fallows follows:]

PREPARED STATEMENT OF JAMES FALLOWS

Thank you for giving me the opportunity to appear before you today. I am here as a journalist and will offer my own personal views, which of course are not necessarily those of my organization. Over the last six years, I have spent most of my time living in or traveling through Japan and other parts of Asia. In that time, I have tried to draw conclusions about the very subject you are considering in these hearings: the relationship between America's economic standing and its international diplomatic power.

This prepared statement covers two main topics. The first part deals with the sources of — and sources of misunderstanding about — economic imbalance between the United States and Japan. The second very briefly suggests some of the diplomatic consequences of that imbalance, and the reasons why each country's political system has had difficulty adjusting to changed economic realities. My main purpose will be to discuss some of the patterns and pathologies of the U.S.-Japan relationship, and to suggest ways in which the most destructive patterns might be changed.

I. Economic Imbalance

It is important to talk about the US-Japanese "economic imbalance," rather than "trade imbalance." As we all learn in our economics courses, a bi-lateral trade imbalance is not necessarily harmful or even significant. Indeed, in a world of complex international trade relationships, it is almost inevitable that trade between any two countries will be out of balance much of the time. Moreover, even if a given country runs a trade deficit not just with specific partners but with the world as a whole, there are many possible explanations for this pattern, some of which may be healthy for all involved. Perhaps the country's industries have been investing rapidly, and must borrow to finance imports of advanced capital goods (as was the case for the United States in late 19th century and for Korea during much of the 1980s). Perhaps interest-rate differentials or other factors have attracted international capital to the country, which by the axioms of economics increases the country's trade deficit. Perhaps macroeconomic policies have given the country's consumers a surge of new spending power, beyond what they have earned through productivity increases. They may spend much of this on goods from overseas. All of these factors played some part in America's trade performance in the 1980s, including in shaping its deficit with Japan.

The trade imbalance between the U.S. and Japan — which has endured non-stop for more than two and a half decades and which during the last decade has been in the vicinity of a billion dollars per week — is significant, therefore, only as part of a larger economic and technological imbalance. No single part of the imbalance, taken in isolation, would necessarily be destructive. If trade surpluses ebbed and flowed, as they generally have between the United States and Europe; if each side seemed to view advanced technology as a matter of "comparative advantage," specializing in some fields but leaving others to be specialized in by its trade partners; if companies in each country seemed to operate in an equally trans-national way, making decisions for purely business reasons with little regard for national borders and loyalties; if the economies seemed to be driven by the same mechanisms toward the same fundamental goals; if any of these conditions applied, then a trade imbalance with Japan would be like many other transitory imbalances in the world. It would not be the subject of discussions like this one today.

But the imbalance with Japan is unique in America's economic experience. It is uniquely large, representing more than half of America's total trade deficits and much more than half of America's high-tech imports. It is uniquely persistent, having continued uninterrupted since the 1960s. There is a unique asymmetry in the two countries' roles in each others' economies. Through the last decade, the foreign-owned share of North American and West European economies has been rising, in some cases rapidly. The foreign-owned share of the Japanese economy was much lower to begin with, and has actually been going down. There is a uniquely one-directional shift of technological capability. Over the last decade, American firms have become much more dependent on technology, components, and processes from Japan. This is especially clear in the semiconductor-chip, semiconductor-equipment, and computer industries. During the same period Japanese firms have become much less dependent on high-value components or processes from the United States. There is a uniquely sharp difference in import patterns, not simply between Japan and America but between Japan and the other industrialized powers in the "Group of Seven." The North American and European economies, including Germany,

overwhelmingly import manufactured goods, including products that their own industries are capable of making. Japan's imports have until recently been principally food, fuel, and raw materials, and much of the increase in manufactured imports in the late 1980s, has been produced and mediated by Japanese firms that have moved lower-value production to other sites in Asia. There has been a unique gap in investment, with Japanese firms out-investing American firms, in absolute terms, in each of the last three years. Since Japan's population is half the size of America's, the per-capita investment difference has been about two-and-a-half to one. There is a nearly-unique gap in consumer welfare between the two countries, with Japanese consumers paying much more than do Americans for nearly all goods, including most that are made in Japan itself.

And, despite America's utter and complete victory over what was the Soviet Union, the Japanese economic record constitutes something unprecedented in America's history: the rise of a model that can out-produce us on our own terms. American economists have talked about the "prospect" of the world devolving into regional trade blocs. It is not yet appreciated in this country that East Asia, the world's fastest-growing economic region, is in effect already a Japan-centered trade bloc. Japan is the leading source of imports, capital, and technology for almost every country in the region. (The main exception is in itself illuminating: the U.S. is, by a small margin, still the leading exporter to the Philippines, which is probably the west of the East Asian economies.) Many countries in that region still respect certain aspects of American performance and power: its university system, its seemingly universal pop culture, its military reach. But throughout Asia there is no contest between the Japanese and American systems as models for industrial development; the Japanese model has clearly prevailed.

Before America can decide what — if anything — it should do about these unique circumstances, it needs to decide how to think about and explain them. In my view, this has been our central problem in dealing with Japan: we don't know what we're dealing with, so we don't know how to respond.

One standard approach is to say that the Japanese practices are "unfair." I think this is neither accurate nor useful. Some parts of Japan's performance, especially its very high investment rates, are unquestionably admirable. Many others, as I will explain in a moment, simply reflect a different economic philosophy, rather than an unfair application of our philosophy and rules.

Another familiar approach, common in both America and Japan, is to explain the economic imbalance in an anecdotal and ad hoc way. American car manufacturers put the steering wheels on the wrong side of the car, no wonder we have a \$40 billion year trade deficit with Japan! American students don't speak foreign languages; Japanese workers are members of a "pure race." Some of these explanations, though not the racial ones, make sense on their own terms. Americans should, indeed, learn more languages. We should save and invest and study more. We should change our tax policies to prevent corporations from paying inordinate bonuses to executives when the company as a whole is suffering and workers are being laid off. But Germany and Korea, which do not suffer from American-style internal weaknesses, have virtually the same difficulties as America when competing with Japan. Americans should understand that something larger is going on.

The "something larger" affecting this relationship is, in my view, the difference between the two versions of capitalism practiced in the two largest "capitalist" economies. The United States has no problem recognizing that cultures can vary around the world, or that people can espouse different faiths or speak different languages. Yet since the end of World War II, it has been hard for us to imagine that any other country — especially a successful and efficient one — could in the long run choose a system of economics different from ours. The Russians, we tell ourselves, chose a different system, and now they're sorry! We don't often say: the Japanese chose a different System, and now they're strong. When we notice that other countries differ from our practices or our professed ideals — by overtly applying industrial policy, by sacrificing their consumers' interests with tariff or closed markets, by deliberately encouraging certain technologies or exports — we have assumed that these must be temporary problems of "immature" economies, which will be outgrown or cast off in time. The evidence of this powerful American assumption turns up every day. For instance, it lies behind the frequent notion that because today's "rich young Japanese" have been raised in affluence, tomorrow's Japanese system will certainly be more spendthrift and consumer-minded, and less dominated by big industrialists, than it has been for the last 45 years. Although it is certainly possible that the Japanese economy is just about to undergo a

major change, we should remember that American observers have consistently predicted such a change for at least 30 years - and so far, at least, they have been consistently wrong.

I believe that the evidence shows the underlying strength of the Japanese economic system, despite the immediate and serious difficulties of the country's financial system. The roots of the current plunge in the Japanese stock market, and the related fall in land values and other asset prices, lie in the 1985 Plaza Agreement, which over the next two years led to a doubling of the yen's value against the dollar. As has been widely reported in the economic literature, this led, in the late 1980s, to both a boom in Japanese investment and a dramatic inflation in Japanese assets, such as land and stocks. For the last two years, the Bank of Japan has led an effort to reduce the distorting effects of this "bubble economy." There is, of course, a danger that the fall Japanese stock market will continue into a truly catastrophic crash, which would destabilize not only Japan's economy but the world's. Up to this point, however, the Japanese "recession" has been largely confined to the financial sector, and not the "real" manufacturing economy. For example, there is still virtually no unemployment in Japan.

Although some American politicians and journalists have gloated about the end of the Japanese "miracle," more serious assessments suggest that in two or three years, the large Japanese manufacturers will seem even stronger than before.

What might constitute the differences between two styles of capitalism? To summarize: the two systems, although both relying on private companies and on market mechanisms, have quite different objectives. When the systems interact, the natural result is the kind of unique imbalance we now observe. Indeed, the root of the US-Japanese economic imbalance is that each system is achieving its desired end. The US system has generally been set up on the principle that consumer welfare matters more than anything else. Therefore, with exceptions like the sugar quota and the Multi-Fiber Agreement, we have generally permitted or encouraged imports, since, they make more goods available at lower cost. Significantly, this was not America's principle or policy during its years of most rapid industrial growth in the late 19th and early 20th century. It was applied as a retrospective explanation for American strength only after World War II, at a time when American industry had no rival anywhere.

The Japanese system, for its own understandable reasons, has had a crucially different purpose: to strengthen the industrial and technological base within Japan's borders or under control by Japanese-owned firms. This goal has obviously been more important than promoting the welfare of Japan's consumers. By paying artificially high prices and accepting much lower wage increases than their productivity would justify, Japan's consumers have in essence subsidized the country's industrial growth — as American consumers did during World War II. From the perspective of Japan's leadership, and even of most of its beleaguered consumers, this approach has made sense. The country needed to strengthen its industries to avoid being colonized in the 19th century. It needed to rebuild to avoid complete dependency after World War II. Its leaders see very little reason to change this successful system now.

There is nothing "unfair" or wrong in this divergence of systems, any more than it is unfair for the French to speak a different language from our own. Unfortunately, the effects of the interaction have become harmful for America. In our role as consumers, we have generally benefited. A trade deficit means by definition that consumers are being subsidized by producers overseas. Competition always makes prices better and companies more efficient. But no society's welfare, not even ours, depends entirely on consumer prices. There are other values to be weighed against having the cheapest possible VCR. We recognize this when we pass environmental legislation, or even child-labor laws. Each billion dollars of trade deficit means subsidized consumption for Americans — but it also means, by the Administration's calculations, 20,000 fewer jobs inside the United States. The disproportionately-large loss of manufacturing jobs has aggravated the already-serious gap between rich and poor in America, making it more difficult for families to earn their way up through the income distribution. Because much of the shift in manufacturing capacity has been from America to Japan, and because Japanese firms have been slower than European or North American firms to open their management and leadership to foreigners, opportunities have shrunk for people who do not fit easily into that system, which includes most members of American society. Nations that are on the frontier of technological development and industrial strength have usually offered their members richer and more varied lives than they would otherwise have. (The loss of élan in British society between the 1890s and the 1950s is one illustration.) It follows that we prepare our children for the prospect of a poorer and narrower

life, in a nastier society, if the U.S. loses its economic and technological leadership. Beyond these economic and social question, of course, America's ambitions as a military power are tied to its ability to produce high-tech equipment.

The crucial change in American policy, in my view, depends on an understanding that time is not on the side of resolving economic imbalances. The two economic systems are not inevitably going to converge. Perhaps they will; perhaps Japan will decide that the country has taken the wrong course, perhaps the students and salaried men and consumers will demand an easier life, perhaps the big industries will lose their knack for investing and competing. But perhaps not — and for policy purposes, it is much safer and saner to assume that the Japanese system will not self-destruct. This observation may sound self-evident, but it would lead to deep changes in our policy. We could stop lecturing Japan on the need to change its ways, and instead accept the Japanese system in being as a permanent addition to the economic scene. We could then act as the Europeans have already done, deciding calmly how we can defend social, technological, and business interests that the interaction of these systems will not automatically defend. Americans and Japanese frequently squabble; Europeans and Japanese rarely do. The central difference is that the Europeans undertake no missionary efforts, from a position of ever-dwindling strength, to convince the Japanese leaders that they muse change their ways.

ii. Political Rigidity

The instability created by this shift in economic fundamentals is obvious. The United States, which has the experience, the habit, and the desire to make sweeping international commitments, increasingly lacks the money to carry its commitments out. The conduct of the war against Iraq was the plainest and, I suggest, most humiliating example. The United States provided skillful political leadership, yet it had to ask others, notably the Japanese and Germans, to help cover the bill. To Americans these requests might look reasonable and fair-minded; other countries benefited by reducing Saddam Hussein's threat to the Middle East, so why shouldn't they pay? But from outside the country, the American requests looked like a combination of begging and bullying. They deeply undermined the impression of a nation capable of all dimensions of leadership.

Japan, meanwhile, has more and more of the financial resources for world leadership, but its political system remains fundamentally unprepared for this job. Most of Japan's difficulties can be traced to decisions made during the Occupation years.

The American Occupation was by most measures a resounding success. The Japanese economy recovered; more-or-less amicable feelings were restored in an amazingly brief period of time; the fascist and militarist tendencies of the 1930s were rooted out. Part of this success was undoubtedly due to the American decision to support and work with Emperor Hirohito, rather than forcing him out or trying him as a war criminal, which some of the other Allied nations were quite eager to do. The American policy toward the Emperor, however, was not "forgive and forget" so much as it was simply "forget." American policy assumed that the Emperor had been an innocent bystander during the war — and that, by extension, Japan's militarist era had been an aberration, which the nation could put behind it with its "Peace Constitution." This approach made for harmonious feelings in the short run. But it encouraged the Japanese tendency not to deal firmly with the causes of the war. Over the last four decades, Germany has been forced, by its own people and by its neighbors, to grapple with its responsibility for the Hitler era. There has been much, less internal debate about the war in Japan. In part this is because of different political traditions within Japan, and in part it is because Japan's neighbors in East Asia are not politically integrated, the way Germany's neighbors in Western Europe have been. Germany's diplomacy in the last generation has been mainly European-oriented; Japan's remains dominated by its relationship with the United States. While the threat of German "domination" remains an issue in Europe, few of Germany's neighbors feel that the country has denied its responsibility for World War II. Japan, since the U.S. Occupation, has largely viewed the war as a natural disaster — that is, as a cataclysm that ruined the country, but the no one in particular caused.

In the 1950, some Japanese made serious efforts to restore the country's role as a "normal" nation — one that would carry out the normal sovereign activities of diplomacy and self-defense. These efforts did not succeed. In accepting a long-term security relationship with the United States, Japan abdicated not only military responsibilities but also most diplomatic duties. In effect, its diplomacy consisted of following the American lead. This policy was meant as a renunciation of militarism and a positive example to the world. Rather than dominating its neighbors,

Japan would renounce war and show the way to economic progress. But, in effect, it created a national system that was optimized for one purpose — economic growth — and for nothing else.

"Nothing else" applied not only to foreign relations, which were delegated to the United States, but also to the development of Japan's own institutions for making political decisions and controlling the use of military force. There was a "reformed alcoholic" mentality to Japan's post-Occupation policy. The military was so dangerous, and militarism had been so seductive, that the country could not afford to take the slightest step toward a "normal" military role. This, again, is in contrast to Germany's steady integration in the NATO military system. Japan, in reality, has been developing a technologically very sophisticated military force. But politically Japan's has had a taboo on even discussing the use of military force. In the meantime, the United States was of course developing a system optimized for the exercise of worldwide political leadership, even at the expense of its internal economic needs.

This post-Occupation division of labor between Japan in America was sustainable as long as two conditions prevailed. One was the Cold War. After World War II, the United States believed that its strategic relationship with Japan was all-important. Economic arguments with the Japanese might be annoying, but they were trivial compared to the prospect of Japan shifting its allegiance toward the Soviets or Chinese. The other condition was a huge difference in scale. The American economy was large, the Japanese economy was small, and to get too concerned about Japanese competition was undignified.

Neither of these conditions prevails any longer. Since 1989, the United States has not had to be preoccupied by the Cold War. Since the early 1980s, it has had to recognize that the scale of Japan's economy is approaching its own. The question both countries face is how the manifest tensions in the relationship will be resolved — whether America can regain economic power to back up its diplomatic pretensions, whether Japan will take on political skills to match its economic might.

I do not presume to know how, or whether these conditions can be resolved. It seems to me that America should devote its attention to its own side of the equation — that is, shoring up its economic foundations, rather than spending time telling Japan how to behave. The exacts means for doing so will obviously be the subjects of long debates. Let me suggest several general conclusions about our economic interactions with Japan, based on my own journalistic work:

- * The United States should have a Japanese policy, in addition to a general economic strategy and a general trade policy. The country has general trade problems, and of course it has grievous social problems. But it also has unique and specific problems with Japan that will not be solved with general means.

- * The United States should have a plan, rather than acting in spasms. President Bush's visit to Tokyo in January was a spasm, like many previous tics of annoyance from the United States. The Japanese leadership, quite sensibly, tries to soothe such spasms with temporary measures. They would have been far more impressed with U.S. determination if the President had left the CEOs at home and had instead discussed long-term needs to reduce America's debt or strengthen its technology. Asking for a plan may be the height of unreality. But as long as the nation has no plan, it leaves itself at the mercy of those who do — including most other nations and the 50 state governments inside America that bid against each other to attract industries.

- * For reasons of its own, the U.S. should attend to its obvious and familiar domestic problems. Logically these are separate from the U.S.-Japanese economic imbalance, but emotionally and politically they are closely connected. In practical terms, it is very hard to convince European or Asian governments that America is serious about reconstruction, as long as it continues its huge budget deficits and its wasteful financial market speculation. A recent report from a European commission points out that the "level and quality of American education" has become an important practical concern for German companies operating here.

- * We should recognize that the solution to our economic and strategic problems lies almost entirely in our own hands. We do not need to bully, cajole, force, or trick the Japanese into doing anything else. Indeed, we should stop spending so much time pressuring or pleading to Japan. Following the example of most other countries that deal with Japan, we can simply change our own practices — and the rules for operation in this country, so as to defend interests that are important to use. In the case of high technology, this would mean applying the Asian experience not of "picking winners," which is quite difficult, but of "making winners," with a supportive

government policy. The U.S. has freely done this in the past in three areas — the aircraft and aerospace industry, mainly through defense contracting; the medical-equipment and pharmaceutical industries, through government funding for health; and American agriculture. We can do it in other areas as well. In the long run, nations whose governments are determined to develop high-value industries will have more of them than nations whose governments declare neutrality about how the economy should grow.

REPRESENTATIVE HAMILTON. All right. Thank you very much, Mr. Fallows. We will go to Mr. Lincoln.

**STATEMENT OF EDWARD J. LINCOLN, SENIOR FELLOW,
THE BROOKINGS INSTITUTION**

MR. LINCOLN. Thank you very much.

I suppose I should start with the Brookings Institution disclaimer and say that the views that I present today are my own and should not be attributed to those of the Institution as a whole, which maintains no position on any issue.

I do want not want to go through my written testimony since you already have that. I find that oral testimony provides a wonderful opportunity to discover what was missing in the written testimony and add what else I would like to say.

I want to start by agreeing very much with Jim Fallows that despite the short-term problems the Japanese are having with their economy, in the long run they continue to have a healthy and growing economy that will continue to provide a strong competitive challenge to American industry.

There has been a great deal in our press lately about the collapse of the stock market, falling real estate prices, but there has been remarkably little real damage to the economy. In fact, even though the Japanese say they are in a recession, recently they announced their first quarter GNP growth rate, which was 4.3 percent.

It will be lower than that for the year as a whole, but certainly they are not in what we would consider to be a recession. In addition to there being a strong economic challenge from Japan, I do want to add something else which I think reinforces what James Fallows was just saying, which is that we are dealing with a country that has had a long record of insularity from the world and represents a cultural tradition that is quite different from ours or of the European countries.

Japan is the first non-Western nation to become an advanced industrial power. I think it was perhaps a little bit more comforting to us a century ago to feel that industrialization was somehow bound up in Western civilization, and it turns out not to be true.

A key issue that we have faced since the end of the War, or perhaps even since 1854 when Admiral Perry first went to Japan, has been how to integrate this profoundly insular and different society into the world in a productive way. It has been resistant to the outside world and yet obviously internally it has been very adaptable. They have brought about a successful industrialization.

In the postwar period, I think their natural sense of resistance to the outside has been reinforced by the political decision to remain away from international political issues in the way that Mr. Fallows described. This, then, brings us to the question of how ought we to be dealing with Japan now and in the future.

I divided my suggestions in my testimony into two broad areas of domestic policy and foreign policy. On the domestic side, unfortunately there is still the obvious need for fiscal adjustment in the United States, which does not solve all of our problems with Japan, but certainly moves us quite far along in that

direction. We would have a better underpinning for our overall relationship if we were not running a large fiscal and current account deficit.

I also suggested that we might consider alteration of tax and accounting rules to cause our corporations to spend less time on financial games and more on the real management of production process. Our general educational system needs some work, but I want to focus most here on my final domestic suggestion which was that we ought to consider the targeted educational program for the United States.

We have had, since the 1950s, a National Defense Education Act. The Cold War is over. I don't think we need a National Defense Education Act. We need an International Economic Competitiveness Educational Act. We need to focus government money on college-level programs for language and area studies for those countries that we perceive as being the most important to our economic future.

In addition to that, I would like to add that perhaps such an act would also increase a focus on engineering, management, and quality control in our undergraduate and graduate business programs. These are things I think virtually any Japanese commentator would be willing to say to the United States, and I must say I agree with them. Then we come to the direct question of how should we deal with Japan directly, and again there are several things that we need to think about in the future.

First, there is likely to be a tendency toward Asian economic integration over the next decade. There is a great deal of informal talk in Japan about moving in that direction if the EC looks too protectionist, or if the United States moves ahead strongly with NAFTA and its extension to other Latin American countries.

My concern is both that Asia is not quite ready for the kind of integration that we have seen in Europe. There is not the history of interaction among these countries that we see in Europe, and that if the United States is not directly involved itself—and many of the proposals do not include the United States—it is likely to take on a protectionist coloring that would not be to our advantage.

The second thing is that we need to do more to drive the Japanese into a multilateral discussion of issues. Once the Uruguay Round is over, I think we will be at a time when there will be serious consideration of the general shape of the national economic institutional framework.

The Japanese must be part of that discussion. That is an area where we can and perhaps should move some of the issues, such as the antitrust policy that we have discussed bilaterally with the Japanese in the SII process. The SII itself I would put less emphasis on. I would not cancel these discussions. I think they have been highly educational for the U.S. Government.

It is still, I think, an unfortunate fact of life that our government possesses very little expertise on Japan, which is broadly true of our society in general. The more that we can engage in discussions with the Japanese on all levels that cause our officials to learn more about the issues and about the internal workings of Japan, the better. But the key issue with Japan, I think, is simply that on a bilateral basis, we do need to keep up pressure on an industry or product-by-product basis to continue the progress toward opening Japanese markets.

Unlike some people, I do believe that we have accomplished something over the past decade, or the past decade and a half, of pressure on Japan. The heavy pressure really started back in the Carter Administration, 1977-78.

I have met a number of American businessmen who feel that it is easier to do business today than it was a decade ago. That may be a weak statement, but it is at least progress.

We now have a Congressional Research Service study that was done last year, which you have probably seen, which shows that our exports of products that were subject to negotiation during the 1980s have increased far beyond the rate of our overall export growth to Japan. This is not a conclusive study, but it is, at least, again, an encouraging bit of data.

I have looked at the ratio of manufactured imports to GDP in Japan, which has been abnormally low compared to other countries. That ratio has risen over the past five years in Japan. It is still lower than in the United States, roughly half the level of the United States. It is still the lowest of the OECD member countries, but it has been moving in the right direction. We want to encourage it to continue moving in that direction.

I might end by adding a bit of an anecdote. I first went to Japan more than 20 years ago at a time when Sears-Roebuck—which I believe was our largest retailer at least at that point—had entered into the Japanese market through a joint venture with the Tobu Department Store, which consisted of a rather discouragingly small corner of one floor of the store where a small variety of Sears products were displayed, most of which had very little relevance to the Japanese consumer market.

I was rather disappointed and really had a sense of how little penetration of American products and American retailing there was in Japan at that point. Last week I was in Tobu Department Store in Tokyo again. They have just remodeled their store. They have increased its size. It is now the largest department store in Japan, and I was rather pleasantly surprised to see that there was a complete reproduction of two of our upscale retailers, the Nature Company and Williams-Sonoma.

To the best that I could see, the things that they sell in their stores here were completely represented in what they had there, so again I think we are making at least modest progress in getting into the Japanese market, but this is a continuing effort. It is not easy. We are dealing with a sovereign nation. There is a limit to what we can do to try and force increased market access, but I think we just need to continue schlocking along on that road.

Thank you.

[The prepared statement of Mr. Lincoln follows:]

PREPARED STATEMENT OF EDWARD J. LINCOLN

The question of American policy toward Japan in the 1990s needs to be prefaced by some consideration of likely economic developments. The following paragraphs make the argument that Japan will remain a serious competitive challenge to the American private sector for at least the remainder of this decade, and that Japanese firms will continue their international investments. American policy must recognize and react to these likely developments.

Recently the American press has emphasized the economic difficulties in Japan in a manner that suggests the economic challenge—or threat, as some would put it—is over. A combination of the stock market collapse and declining real estate prices has created some financial difficulties. Combined with a general overheating of the economy over the past several years (with real economic growth exceeding the long-run potential), these developments have caused a weakened economic performance this year.

The late 1980s were an extraordinary time in Japan. Faced with strong yen appreciation after 1985, the government stimulated the economy mainly through monetary policy—lowering interest rates (with the discount rate down to 2.5 percent from early 1987 to mid-1989) and expanding money supply. At one point, some firms were actually able to issue bonds with warrants at close to zero interest yields. These extremely low interest rates brought a surge in productive investment; real economic growth from 1988 through 1991 averaged 5.2 percent annually, and corporate fixed Capital investment averaged 11.6 percent. High economic growth could not continue because it was considerably higher than the annual 3.5-4.0 percent GDP growth range assumed by most economists to be the long-term growth potential at the time. In addition, monetary expansion led to unusual speculative bursts of buying in the real estate and stock markets. Disturbed by the potential consequences of speculation, the Japanese government then tightened monetary policy, causing stock market prices to fall by more than half, and, more recently, a real decline in real estate prices. Japanese firms no longer face a major advantage over their foreign competitors because of lower Capital costs.

However, it would be a great mistake to suppose that the economic challenge from Japan was a just temporary bubble. The Japanese may not be ten feet tall, as they seemed to be in the late 1980s, but they will remain serious competitors. Collapse of the stock and real estate markets has resulted in the bankruptcy of remarkably few firms, and the major financial institutions should weather the problem of bad loans without great long-term damage, although their international lending may be disrupted for some time because of difficulty in meeting the new BIS bank capital ratios).

Even though economic growth will decelerate this year, economic growth will remain positive; this is not a recession in the American sense. The slowdown is causing a drop in investment, but the ratio of investment to GNP will remain high relative to the United States. In 1991, the ratio of fixed Capital formation (residential construction, corporate fixed investment, and government fixed investment) to GNP was 31 percent in Japan, compared to roughly 17 percent in the United States, and even slower growth in Japan will leave a visible gap. A higher share of fixed investment in GDP means that the Japanese will be acquiring new plant and equipment, roads and sidewalks, houses, and other infrastructure related to the quality of life at a more rapid pace than is the Case in the United States.

Over the rest of this decade, Japan's economic performance is likely to remain at or near the upper end of OECD-member nations. Most Japanese forecasts assume that Japanese growth will remain above that of the United States until at least late in the decade, although the disparity will not be as wide as in the past. The current Japanese government forecast through 1996 anticipates an annual real growth of 3.5 percent, which may be overly optimistic. But even a conservative estimate of 2.5-3.0 percent could place Japanese growth somewhat ahead of that of the United States.

Several factors enter into these favorable economic growth forecasts. First, technological change and productivity growth continue at a relatively rapid pace even though Japan has reached the global technological frontier. Japanese firms are rapidly proving that they can do more than import and adapt technology from other countries. In some areas, such as superconductivity, Japanese firms are at the forefront of research and development and are likely to be the world leaders as these technologies reach the market. Manufacturing firms place heavy emphasis

on constant change and improvement, and that focus remains even though the lack of a capital cost advantage will dampen their investment in new technology from the heady days of the late 1980s.

Second, the educational system continues to produce a relatively high average education level, with relatively few students who drop out of the system. As production technology becomes more complex, reading, mathematics, science, and problem-solving skills are continuing to become more important for blue collar workers, and the educational system in Japan provides a high proportion of workers with the necessary skills.

Third, social cohesion remains high in Japan. Despite all the talk about a completely different younger generation, change appears to be rather mild. Not having experienced the war or the poverty of the early postwar period, young people today represent an attitudinal shift somewhat akin to that of the United States in the 1960s. But the rejection of traditional values is far less pronounced than in the United States, and even if it were, the number of people involved is insufficient to lead a social revolution. Those now entering their twenties in Japan represent a baby bust generation. Therefore, social change should continue at a modest pace with a continued emphasis on a strong work ethic.

One critically important change will affect economic performance increasingly as the decade progresses. Demographic trends imply that the population pool from which the labor force is drawn will begin shrinking in absolute terms from 1996. Optimists believe that increased labor force participation by women will offset this population decline for several years, but this should be judged unlikely (since a relatively high 49 percent of adult women are already in the labor force). The reality is that Japan is now facing a serious labor constraint unlike anything in its previous history.

A halt to labor force growth means that even a successful economic performance in this decade will result in an annual real GDP growth rate of only two to three percent. But even an overall growth that is no higher than that of the United States by late in this decade means that per capita income will still be rising faster because of the stagnating population growth. With this modest overall growth at home, any Japanese corporation seeking continued corporate expansion must necessarily place a greater emphasis on increasing its global presence.

A second implication of demographic change is that Japanese firms will be at the forefront of technology and investment to lower labor inputs. Expanded application of industrial robots and numerically controlled machine tools, automated materials handling systems, computerized inventory control, and other technologies will be pushed rapidly in Japan with explicit government assistance to cope with labor shortages. Not only do these technologies reduce production costs, they also tend to increase product quality (as measured by defect rates). American firms will continue to feel competitive pressure, both in industries producing production equipment, and from industries incorporating new manufacturing technologies.

A third implication is that Japanese firms will continue their direct investment overseas. The collapse of the stock market in Japan may mean that the surge in speculative real estate and other portfolio acquisitions abroad is largely over. But for the manufacturing sector, the continued labor pressure provides a real incentive to invest overseas because technical change and investment at home provides only a partial offset. The logical location for the bulk of this investment is Southeast Asia, because of a combination of factors such as geographical proximity and high educational levels. Investment in the United States will also continue, though motivated more out of fear of protectionism or a desire to be near major markets rather than out of labor cost considerations.

Continued strong economic performance coupled with these demographic shifts imply that a strong competitive challenge from Japanese firms (and especially in high technology sectors) will continue to face the American business community. Meeting that challenge in a productive fashion is important to our own economic future. Furthermore, Japan's economic success has propelled the nation into a more prominent role in global economic and political affairs, and integrating Japan in a productive manner into the discussion and solution of global issues is a serious task. Coping with the economic challenge from Japan demands two categories of response—domestic U.S. policy and foreign policy.

Japan is certainly not a threat to the United States in the sense that the Soviet Union was during the Cold War. The danger is not nuclear war and a massive destruction of life. Failure to deal

adequately with the challenge from Japan leads to a less dramatic but important consequence: a relative decline in American living standards compared to those in Japan. We may not feel less wealthy at home, but will gradually see a difference in international comparison. Ultimately, a relative decline affects our ability or willingness to continue as a leader in world affairs. A declining dollar can offset unfavorable trends in manufacturing competitiveness, but does so at the cost of cheapening the real value of our dollar-denominated foreign aid, raising the cost of projecting military power around the world, and lowering the price of American assets to Japanese and other foreign buyers.

Domestically, several policies are necessary to deal with successfully with Japan and prevent a relative decline:

1. Fiscal adjustment. The need to reduce the federal budget deficit remains, and hardly needs to be restated. Fixing fiscal policy does not solve all the problems in U.S.-Japan relations, but it certainly provides an important and necessary underpinning for successful competition with Japan.

2. Alter tax laws and corporate reporting requirements to lessen corporate takeover activity and lengthen the time horizon of corporate management. The Japanese rightly believe that Americans put far too much energy into manipulating corporate assets in the 1980s and too attention on improving productivity and product quality. While we certainly do not want to eliminate the role of equity markets, the attention of management should not be unduly diverted by financial games.

3. Improve the quality of public education. With or without competition from Japan, improvement in the standard of living in the United States implies that workers must operate in a more productive and sophisticated setting. Failure to provide a high average educational level, or to reduce the number of students who fail to progress satisfactorily through the system, imposes economic costs on the United States and endangers our economic future. We do not need to emulate the educational system of Japan, which has many faults of its own, but we do need to improve the overall quality and consistency of our own system.

4. Provide additional government incentives for education related to international competitiveness. During the Cold War, Congress-passed the National Defense Education Act. Even today, this law provides funding for students and university programs in international studies. The time has come to alter this focus with legislation that could be given an attention-getting title, such as the International Economic Competitiveness Education Act. Through the provision of federal funding, we can emphasize training in language and area studies of those countries of greatest impact on our international economic performance, and especially Japan. Funding should also be aimed at graduate education, to increase the pool of trained specialists to teach our students in the future. The United States at the present time continues to have a critical shortage of trained professionals on Japan, and in the absence of strong domestic financing, we are making our universities unduly dependent on finding from Japanese sources for their programs.

5. Reconsideration of government policy toward high technology industries. During the Cold War, we justified support for research and development on national security grounds, with civilian spinoffs as a side benefit. Now we need to reformulate both the rationale and the content of our entire science and technology program.

Pursuing these domestic policies does not solve all our problems with Japan, but would move us far along in the right direction. In addition, several foreign policy actions directly related to our relationship with Japan are necessary:

1. Continue pressure for access to Japanese markets for goods, investment, and technology. We have made real progress in removing onerous impediments to the Japanese market over the past decade. But, in my estimation, access problems remain substantially greater than in other markets. Educational policies, to produce more people in our own business community capable of understanding and dealing in Japan helps our ability to penetrate Japanese markets or obtain access to Japanese technology. But in addition, a strong government policy of negotiating for freer access must remain, with the greatest priority placed on high technology markets.

2. Continue the SII process, with low expectations. Most of our problems with Japan must be pursued on a product or industry basis. Nevertheless, the SII talks have not been entirely wasted. At the very least they have served as an educational exercise for an American government bureaucracy that had little previous knowledge or understanding of important aspects of Japanese

economic and policy structure. But some of the issues raised are sufficiently difficult and involve such heavily entrenched vested interests (such as land taxation policies) that substantial progress is relatively remote.

3. Engage Japan in multilateral economic discussions. when the Uruguay round is over, the time will come to seriously consider the future shape of the international economic system. Some issues considered bilaterally in the SII talks more properly belong in a multilateral framework. Antitrust policy is an obvious example of such an area; wide disparity in national antitrust policies can have a major impact on international competitive outcomes and agreement among the major industrial nations on acceptable variations in policy would be an important element in forging a stronger international economic institutional framework. Because is it such a large economy, Japan must be engaged in these discussions.

4. Avoid the creation of a preferential economic zone in Asia. There is much loose talk in Japan of forming a trade bloc with other Asian countries in response to European economic integration and the possible formation of NAFTA (and its extension to other Latin American countries). Japanese interest in the region will intensify as firms continue to invest in the region, seeking lower labor costs in the 1990s. Such a regional grouping could quite likely take on a distinctly protectionist coloring, especially if dominated by Japan, and ultimately could lead to instability in the region if other nations found the relationships too confining. At some point in the future, intra-regional Asian political and economic relations may progress to the point where economic integration becomes feasible or even desirable, but that point has not been reached yet.

REPRESENTATIVE HAMILTON. Thank you, Mr. Lincoln.
Mr. Aho, please proceed.

**STATEMENT OF C. MICHAEL AHO, DIRECTOR OF ECONOMIC STUDIES,
COUNCIL ON FOREIGN RELATIONS**

MR. AHO. Thank you, Mr. Chairman, Senator Bingaman. It is a pleasure to appear here today to discuss economic diplomacy with Japan.

As you mentioned in your letter of invitation, the world has changed, the Cold War is over, Japan is now an economic superpower, and I think as a result the focus of great power competition in the years ahead is shifting from the military to the economic realm.

In that context, it seems to me that the United States in the past used to subordinate its economic objectives out of a desire not to alienate allies is now going to more aggressively, and ought to more aggressively, pursue its economic aims.

We have a little less leverage than we used to. They don't need our security umbrella quite as much as in the past. Therefore, we need to establish a better understanding of what our objectives are and what the obstacles are to the achievement of those objectives.

You mentioned Mike Mansfield in your statement. I would argue that the U.S.-Japan alliances, if it is not the most important in the world, it is probably in the top two, and we often forget as we are criticizing and hurling grenades at one another that we are the two largest industrial democracies that produce 40 percent of GNP. We are the technological superpowers here that are producing the most advanced science and technology.

Japan is our largest creditor. We are their largest market, and if you think about security things in the Far East, it is the U.S. security umbrella—and I dare say most of the Far Eastern nations prefer that the United States remain engaged—but Japan is surrounded by three potential nuclear threats—China, the Korean Peninsula and Russia.

We have and we share, both countries, common interests from increasing worldwide growth and improving the environment, stimulating development and all the rest of it, but we often find ourselves at odds about who is going to bear the burden. And I think we are going to hear more of that in the future.

One of the most frequently heard words in Tokyo of late has been reAsianization—whatever that is going to mean—but it is this bloc stuff that Ed was talking about. I am afraid that in this context in the years ahead, we may end up with more frictions with Japan, which might tug at the fabric of this most important alliance.

I think American policymakers and business people too often, for my money, seem obsessed with Japan playing unfairly. Our problems with Japan are primarily homegrown. Over the last dozen years, there have been dozens of reports about U.S. competitiveness, and they inevitably come to the same conclusions.

In one of the first comprehensive reports, the *President's Report on U.S. Competitiveness*, produced in 1980, concluded over the past two decades—this is from 1960 to 1980—the United States has suffered an erosion in its competitive position in world markets and in the domestic market. This

conclusion is based upon extensive empirical research, and a consistent explanation is that the decline in U.S. trade performance is the result of changing world resource supplies and technological capabilities.

Pardon the jargon here, but I will get to it. These changes are the result of differences in the rates of growth across countries of net investment in equipment and research activity, and the acquisition of skills through education and training. To the extent the United States undertakes less real investment and devotes less resources to research and development than its competitors, then the long-run international competitiveness of U.S. industry will be reduced.

The United States needs to encourage investment and research to prevent such a decline. Expanded investment and innovative activity and more emphasis on education would not only improve the U.S. long-run competitive advantage, but would also contribute to the productivity growth which is necessary for the Nation to enjoy real income gains in the future.

That was 1980. It turns out that that was in my testimony before this Committee in July 29, 1980, but what have we done for the last 12 years? I mean, what did we do during the 1980s?

We went out on a consumption binge, investment as a share of GNP went down, consumption goes up, our savings and investment performance was abysmal. If you were to do the comparison of the key indicators with Japan today in terms of investment to Gross National Product or investment per worker, we are worse now than we were 12 years ago.

If you were to look at our educational performance, it is worse now than 12 years ago. If you were to look at research and development, especially with the Defense Department getting out of the R&D business, Japan has now moved ahead on research and development as a percentage of the Gross National Product, and in fact I think that some people say that as far as private industry is concerned Japan is now doing more research and development than the United States.

If you look at our infrastructure, we are last among the major industrial countries in the world. What have we been doing for the last 12 years? Well, you know, the prescription that came out in 1980 and that we heard in all these reports throughout 1980s is still clear. You have to stimulate savings and investment. You have to improve education. You have to enhance research and development, rebuild infrastructure, do more training and all the rest of it, but we haven't been doing it. We haven't gotten the message. Either we don't have the commitment, we don't have the patience, but we sure ought to get on with it, but what will it take to stir us to action?

Short of some crisis or precipitous event, the only thing that is prodding us to do that is the Japanese competitiveness. I think the last thing we should do is to try and stifle that competition at the border or whatever. All right.

Having said that, a few obligatory words on Europe, for a moment, because we are the three regional blocs emerging in the world. It is not going to be just U.S.-Japan relations in a vacuum. I am afraid few look at the full plate of activities and reforms going on in Europe—from creating a Europe without borders to a single central bank, to trying to figure out how to enlarge, to what to do about Eastern Europe and all the dislocations and migration problems, to trying to correct their own democratic deficit—the European Community will be perennially preoccupied for the next decade and beyond.

In fact, I dare say, in a government-to-government basis, it will be the community that is going to give the U.S. Government more fits than Japan. Japan is a competitive challenge, and if we are talking about options for reforming global international economic institutions, the community is likely to be the frustrating foot dragger that causes us not to achieve whatever objectives for better organizing the world.

Let me just lay out a few policy challenges and possible responses in the years ahead. I mentioned three economic blocs willy-nilly are being formed. Whether these blocs are benign or belligerent will depend, one, on the strength of multilateral institutions and, two, on American involvement in each of those blocs. On both of those scores, I have some concerns. I don't think the GATT, the IMF and the World Bank can discipline the emergence of these blocs, at least as they are now created. But second, I think that with respect to the emerging economic bloc in the Far East, America is losing its influence. It is being reduced.

American businesses are retrenching. If they are not pulling out, they are not increasing. The annual inflows of investment are smaller. Japan is taking over in the Far East. Now, we have President Bush, who has suggested that we have a Western Hemisphere Free Trade Agreement, go beyond NAFTA, United States, Canada and Mexico, to include all the Americans.

My question is why do we want to do that? Why do we just want to do a Western Hemisphere Free Trade Agreement with indebted developing countries in Latin America? I have nothing against those countries, but why just include those countries, and why not leave it open to the dynamic countries in the Far East? Because if we are just doing a Western Hemisphere Free Trade Agreement, what signal are we sending to our businesses about where they ought to invest?

They have a bigger incentive to invest in Mexico than on the margin going to Singapore or wherever, and what signal are we sending to those countries in the Far East that are concerned about our own preoccupation in this hemisphere? We have had a Malaysian proposal for East Asian economic grouping, which has been put down by the Japanese and others, but I think that would be the first among many proposals we will see in the years ahead.

I think we have not thought through our own incentive structure of what we ought to be doing on trade policy in the future. I dare say, I know for well-known historical reasons, many of these countries in the Far East are concerned about having an economic bloc centered around Japan, but in the 1990s, there is going to be a scarcity of foreign direct investment capital—there is going to be a scarcity of capital in general—and if these blocs in Europe and the Americans are exclusionary, what accommodations are these Far Eastern countries willing to make to entice Japanese investment to come there? Can some institutional innovation be far behind? Will they have to put together a bloc? I think we are setting up the wrong incentive structure, quite frankly.

Briefly, on the Uruguay Round of multilateral trade negotiations, it will be completed and implemented some time early next year, but it will come up with a minimally modest result which will disappoint influential domestic constituents in agriculture, services and intellectual property. It will not

include the issues with which we have the most problems or most concerns vis-a-vis Japan.

Ed mentioned competition policy, read their keiretsu and enforcement of antitrust. How about what policies are legitimate to use in the promotion and development of high technology industries, emerging problems and the interaction between trade and the environment, and finally, what format do we need to scrutinize the emergence of these economic blocs because they are inherently discriminatory.

We had, I think, a halfway decent start with the SII talks. That probably needs to be multilateralized, though. I don't know if it is at the OECD or elsewhere. We have to go further on that, but more than anything else I think we need, when the Uruguay Round ends with its minimally modest result, an ongoing multilateral process.

You know, rounds to some degree have outlived their usefulness. You can't negotiate for six or seven years and then take six or seven years off. I mean this round of negotiations is negotiating a 1970s issues. When are we going to get on the to 1990s issues? In the year 2010?

We have to establish an ongoing stronger discipline, world trade organization, whatever can help to constrain the emergence of these blocs and also can deal with issues as they arise.

Let me briefly say something about two other areas, and that is macro-economic and exchange rate coordination, and then a little bit on development aid. The economic summit process, you know, isn't binding. The commitments that are made there are not followed up.

There is no institutional follow-up in all this, but as you get the emergence of three giants on the world's economic stage, each one of those giants can potentially cause problems and economic hardship for the other two if they are not going along, if they are not in sync.

We need to improve that process of coordination at this stage. We haven't done it. These summits are really photo opportunities. We have to think about a permanent secretariat, about follow-up meetings and everything, and improve economic coordination, otherwise we will see increased instability in the years ahead.

Finally, on aid and development policy, Japan clearly has a bigger role to play. This is where they could bear the burden, but burden-sharing also implies power sharing, and if the United States is shrinking or shirking its responsibilities on aid or assistance to multilateral organizations, we are going to have to realize that Japan is going to have a bigger say in all this, and we are going to have to accept that.

I would conclude by saying that I am an optimist in the 1990s. It is not 1918, it is not 1945. We have a real opportunity to do some international economic institution building, and we ought to get at it because the United States, if it continues to have these poor indicators on competitiveness, as I was suggesting before, will have less clout 10 to 15 years from now. We may as well do it while we still have some.

[The prepared statement of Mr. Aho follows:]

PREPARED STATEMENT OF C. MICHAEL AHO

Mr. Chairman and members of the Committee, it is an honor and a pleasure to appear here today to discuss "Economic Diplomacy with Japan." As mentioned in your letter of invitation, the world has changed -- Japan has emerged as an economic power and the cold war has ended. As a result, the focus of great power competition is shifting from the military realm to the economic realm. When you throw in a revamped and revitalized European Community, the agenda for economic diplomacy is complicated and possibly contentious particularly because the United States, I believe, will and should pursue its economic objectives more aggressively.

In the past, foreign economic objectives were often subordinated to security concerns in a desire not to alienate allies. But without the constraint of the Cold War, America will not be as reluctant to aggressively pursue its economic goals. At the same time, it will have less leverage because Europe and Japan are less reliant on U.S. military protection. As a result, a more assertive America will confront a more assertive world, a prescription for confrontation. But that means we need to develop a better understanding of where our economic interests lie and of what are the most significant obstacles to achieving our objectives.

In the midst of acrimonious trade tangles we often overlook the fact that the United States and Japan share one of the two most important, if not THE most important, alliances in the world. The enormity and scope of our relationship is frequently lost in critical commentary about and counterattacks on each other.

- the U.S. and Japan, the two largest industrial democracies in the world, produce over 40 percent of the world's gross national product

- the two countries possess and produce the most advanced science and technology
- Japan is the U.S. 's largest creditor and the U.S. is Japan's largest market
- Japan is surrounded by potential nuclear threats in China, Russia, and the Korean peninsula and is dependent upon the U.S. security umbrella.

Both countries share common interests in increasing worldwide growth, reducing exchange rate instability, fostering economic development, protecting the environment, and promoting peace and prosperity. And yet we are increasingly at odds over the distribution of the burden. Such disputes are likely to proliferate in the future because our alliance with Japan will need to be put on a new, more equal basis. This will not be easy for Americans or Japanese to accept. But it must be done. We can not let frictions tug at the fabric of our relationship. Despite all the talk of a Western Hemisphere free trade agreement in Washington and "ReAsianization" in Tokyo, we can not retreat into rigid regionalism without our mutual prosperity suffering. Nor can we allow reciprocal accusations of unfairness or threats of sanctions and retaliation derail our efforts from building a stronger relationship.

American policymakers and businesspeople often seem obsessed with what they feel Japan may be doing unfairly to gain advantages over U.S. firms. Their myopia is blinding them from recognizing the major causes and effects of the competitive challenge from Japan. Our problems with Japan are primarily home grown. For over a dozen years, dozens of reports have been written on U.S. competitiveness and they inevitably come to the same conclusions. In one of the first comprehensive reports prepared by the Labor Department in 1980, it was concluded:

Over the past two decades, the United States has suffered an erosion in its competitive position in world markets and in the domestic market. This conclusion is based upon

extensive empirical research which analyzed the trade of 34 countries in over 100 commodities... A consistent explanation emerging from our analysis is that the decline in U.S. trade performance since the early 1960's is the result of changing world resource supplies and technological capabilities. These changes are the result of differences in the rates of growth across countries of net investment in equipment and research activity, and the acquisition of skills through education and other training.

Competitive advantage does not remain constant. Research and development and investment in capital equipment and labor skills are key factors which affect the long-run competitive position of a country and they are also the major sources of productivity growth. To the extent the United States undertakes less real investment and devotes less resources to research and development than its major competitors, then the long run international competitiveness of U.S. industry will be reduced. Over time, larger capital expenditures overseas in newer facilities will enhance the competitiveness of foreign firms. Increased research and development will enable them to develop newer products and processes with which U.S. firms will have to compete. Although depreciation of the dollar will make U.S. products look more attractive in world markets, this will reduce our real income and overall welfare at home. Not doing enough to lower costs and develop newer, higher quality products may lead to a long-run structural decline in the U.S. competitive position in manufacturers and even in high-technology manufactures.

The United States needs to encourage investment and research to prevent such a decline. Expanded investment and innovative activity would not only affect U.S. long-run competitive advantage, but would also contribute to the productivity growth which is necessary for the Nation to enjoy real income gains in the future.

That excerpt was drawn from a testimony by me before this committee on July 29, 1980.

The prescription is still clear — stimulate savings and investment, expand innovation and R&D, improve education and rebuild infrastructure. Not surprisingly, this is Japan's agenda for the Structural Impediments Initiative. But America's problem is like the middle-aged man or woman that goes for a physical and the doctor can pinch an inch of fat. The doctor prescribes coming down on calories and increasing exercise. That is boring and it takes a long time to demonstrate results. Up until now, America has lacked the commitment and patience to improve its competitiveness. What will it take to stir us to action? Short of a crisis or a precipitous event, the only thing that is prodding us to do better is the Japanese competitive challenge. We should

welcomes the competition, not try to stifle it.

Furthermore, Japan is not the only threat to America's interests in the years ahead. Contrary to widespread public opinion, the United States (and Japan for that matter) could have greater government to government problems with the European Community in the future. In its effort to create a Europe without borders, the EC is changing the internal rules of the game often to the disadvantage of outsiders. To achieve a more dynamic, unified community, the EC is breaking up the separate national cartels that characterized Europe and as a result, widespread dislocations are likely. Moreover, the European Community has an overloaded plate of political issues confronting it over the next decade. A common currency with a European central bank can only be achieved in a two speed process. Some countries will inevitably be on the outside of the new central bank looking in. The EC still needs to enact institutional reforms to correct its "democratic deficit" and to streamline its decisionmaking processes. New members will be admitted to the EC in the next few years, but which countries and on what basis? Political and security affairs will remain a source of contention as the Community wrestles over what could constitute a common defense posture and foreign policy.

With such wide ranging issues at play and the possibility of significant dislocations perhaps exacerbated by a recession and/or a flood of immigrants fleeing the former Communist states of Eastern Europe and the republics of the late Soviet Union, the EC will have its hands full. When push comes to shove, time and political will are scarce resources and the outside world could find that engaging the EC in multilateral initiatives is a challenge of the first order. Without sufficient prodding from the outside world, the EC could become perennially preoccupied. The EC's stubborn refusal to make further concessions on reducing agricultural

subsidies in the Uruguay round of multilateral trade talks could be a harbinger of things to come. For some time to come, the EC will define the global options available for reforming the international economic system and for improving the management of interdependence.

Let me conclude with some policy challenges and possible responses in the years ahead as these three economic giants confront each other on the world's stage.

If we are not careful and do not manage economic interdependence well, the potential exists for the world to fragment into three economic blocs. Whether these blocs are benign or belligerent will depend upon the strength of multilateral institutions and on the extent of American influence in each of the blocs.

On both of these scores I have concerns. The multilateral institutions, GATT, the IMF and World Bank currently lack the authority to discipline bloc behavior. And with respect to the emerging economic bloc in the Far East -- centered around Japan -- the United States is losing influence. American investors in the region are retrenching and U.S. trade policy as articulated by President Bush is to create a free trade agreement in the Americas. Why restrict it to the Americas? Why not leave it open to the dynamic countries of the Far East? Rather than establishing a framework to expand U.S. trade and investment in the Far East, the Administration is establishing incentives for the countries in the Far East to band together in their own bloc. The Malaysian proposal for an East Asian Economic Group could be just the first of many such proposals.

Now it could be argued that for well-known historical reasons many countries in the Pacific are quite wary of establishing an economic unit centered on Japan. But in a world of scarce investment capital and perhaps reduced access to the other blocs in Europe and the

Americas, what accommodations will those countries be prepared to make to entice Japanese investment and to promote regional economic growth? Indeed, the Japanese share of investment in the region is increasing and has outstripped U.S. and EC investment without governmental involvement or negotiation. If the U.S. and EC become preoccupied with their respective regions, could institutional innovation in the Far East be far behind?

The Uruguay round of multilateral trade negotiations will probably be completed and implemented early next year. But the round will certainly disappoint influential domestic constituents in this country because of insufficient progress on services, agriculture, investment and intellectual property. And it will include little or nothing on competition policy, on what policies are legitimate to use in promoting high technology industries, on the environment or on how to constrain the emerging economic blocs in Europe, the Americas and the Far East. If no provisions are made for an ongoing multilateral process, the United States will only be left regional agreements and aggressive unilateral action to resolve festering trade disputes. The SII talks produced results and should be modified and continued if for no other reason that both countries are learning more about each other. But this process needs to be extended to include Europe and the dynamic countries of the Far East that also pose problems for American firms. Indeed this process should be multilateralized if not at GATT then at the OECD or a comparable Pacific forum.

With greater symmetry among the major economic actors — the European Community, Japan and the United States — the need for and benefits from cooperation go up. But three actors increases the risk of instability especially when the actions of any of the three can damage the interests of the other two. At present, the economic summit and G-7 coordination process are

inadequate because the commitments made are not binding and there is no institutional follow-up. If these processes are not strengthened then coalitions will be needed to prod progress. The U.S. and EC share a common interest in opening up Japan. On the other hand, the U.S. and Japan have a common interest in keeping the EC open for business and engaged in trade liberalization. Can the day be far away when the EC and Japan want to gang up on the U.S. say because of protectionism or footdragging on international institutional support?

The G-7 process of coordination among the major industrial economies needs to be rejuvenated. In the future, U.S.- Japan or U.S.-European relations will not play themselves out in a vacuum, but are only one leg of an emerging tripolar world, involving Europe, Japan and the United States. The recent disparity between G-7 interest rates -- especially the gap between German and U.S. interest rates -- highlights fundamental differences over how to deal with the current global recession and the threat of renewed inflation. It is time for better coordination of economic fundamentals to avoid exchange rate instability and economic policies that work at cross purposes. To ensure coordination and follow-up to decisions reached at the Economic Summits, the G-7 needs a permanent secretariat. Discussion should begin on how best to enforce joint economic commitments. And the extension of G-7 cooperation into the political and other realms should be explored.

Finally, on aid and development policy, Japan has a bigger role to play in bearing global burdens. Although it is already the largest donor of aid, Japan will increasingly be approached to provide assistance. This burden sharing is entirely appropriate for a rich, surplus country like Japan. But burden sharing also means power sharing. The United States and other industrial countries can not expect Japan to pay without being able to influence or decide what the money

is going for. Tied assistance is to be avoided but beyond that a variety of forms and avenues for assistance are available. If the United States is going to reduce its aid effort and be a frustrating footdragger on multilateral assistance, America will have to learn to live with a larger Japanese role.

The 1990s would seem to be a more propitious time than 1918 or 1945 for international institution building. Now is the time to define the objectives and functions of any new institutional architecture and determine who participates. Institutional innovation at the global level would be the best means for minimizing U.S.-Japan frictions while the U.S.-Japan alliance is strengthened through ongoing bilateral processes.

REPRESENTATIVE HAMILTON. Okay. Thank you very much, Mr. Aho.

We will now turn to some questions. Thank you for all of your statements. Let me begin with some general questions with respect to the attitude of our Americans, our constituents toward Japan. We had Mr. Yeltsin here yesterday, and he told us that communism is dead, and Russia is moving in the right direction for us. Americans don't seem overly concerned about Russia anymore, don't see the Soviet Union as a threat, but if you walk down the streets of most American cities, they would identify Japan as the threat to the United States.

In the sense that they are more worried about Japan than any other country in the world, they are worried about Japan because, in a word, they are worried about their jobs and their wage levels. Now, is that a fair concern or fear that Americans have? Are we going to be losing our economic position to Japan in the years ahead? Are they going to continue to beat us on productivity and growth, and are we going to have more and more problems with Japan? Are the American people right to be so deeply concerned about Japan?

MR. FALLOWS. Perhaps, as the main nonexpert here, I can answer this ballpark public opinion question. First, I would feel more reassured if people really were consistently thinking and worrying about Japan. I think one of the basic problems in America is that we find it hard to think about any foreign country and certainly not more than one at a time, so when something happens in Iraq, Japan disappears. So, if we thought about Japan one-tenth as much as they think about us, that would be a good thing in focusing our policy.

Second, it is my impression that there are separable elements of this threat feeling about Japan which reflect separable, real phenomena in the world. On the one hand, my understanding is that public opinion polls show that when people say they are worried about Japan, what they are really saying, to a large extent, is that they are worried about America. All the things that are going wrong here is a proxy for projecting what we don't like about schools, budget deficits, etc., etc.

On the other hand, there is a thread in this worry which reflects some critical feeling about how Japan plays the game, and are they playing the same game that we are playing. I think those two elements are worth constantly keeping separate as we think about what we should do. This is one point where I would disagree with Mr. Aho, and I think it is worth spelling out the disagreements for you.

I think it is misleading to say that either the problem is all made in America or all made in Japan, because that implies there is one big problem that is one person's responsibility or the other—just like there is one big threat from Japan. Obviously, as you know very well, and as we have all discussed, there are terrible systematic problems in America that we should correct whether or not Japan existed, and we should deal with.

On the other hand, there are problems of dealing with Japan that other countries have, too. The Germans and Koreans don't have the same school problems that we do, but they have the same problems with Japan.

REPRESENTATIVE HAMILTON. So, Mr. Fallows, what do you say to the person who says they are worried about Japan and the threat? Do you say to him,

relax, or do you say, no, you have a big challenge here, you better get to it? What is the message?

MR. FALLOWS. I would say the latter. This is something to take seriously, and the way to take it seriously—what we should do about it is to repair things that we can repair—to repair our own system. So, yes, my message would be, on the whole, you should worry, you should take it seriously, and you should do constructive things about it.

REPRESENTATIVE HAMILTON. Are we in for the economic fight of our lives with Japan?

MR. FALLOWS. We are in for something that none of us has experienced in our lifetime and in our Nation, not in a century, which is a system that can outproduce ours. So, in that sense, yes.

REPRESENTATIVE HAMILTON. How about the rest of you, Mr. Lincoln, Mr. Aho, do you want to comment? Mr. Fallows referred to Mr. Aho's statement. I think he said our problems with Japan are homegrown, if I remember your phrase. So you might pick up on that, too.

MR. LINCOLN. Part of the problem is the term "threat." The Soviet Union represented a threat in which if we didn't work it right, either we or they or both of us would be dead. That is not the kind of threat that Japan represents. It is not entirely clear that the threat they represent is one in which they necessarily win and we lose. It could work out that way, but it could also be a situation in which they win and we win, and that is what we want.

REPRESENTATIVE HAMILTON. You think it will work out that way?

MR. LINCOLN. It could.

REPRESENTATIVE HAMILTON. Do you think it will?

MR. LINCOLN. I am always an optimist. I would like to believe that.

REPRESENTATIVE HAMILTON. That both will win?

MR. LINCOLN. That both will win. But that requires that our response to the notion of Japan being a threat that we do something to ourselves in terms of policy at home, and that we put more attention on to the way in which we deal with Japan through economic and foreign policy. If we do those things, then we benefit, and I think we both win.

REPRESENTATIVE HAMILTON. How do you personally feel, though, about the Japanese threat, as you have described it? Is this something you really worry about? Is the American justified in his feeling that Japan is a big threat to our economic well-being?

MR. LINCOLN. Well, personally I would use the word "challenge" and not "threat." In a way—

REPRESENTATIVE HAMILTON. Japanese competition is good for us; is that your view?

MR. LINCOLN. It is good for us if we meet the challenge. It is bad for us, perhaps, economically and politically if we choose not to meet the challenge. It is bad for us in the sense that if we allow them to monopolize certain markets, as perhaps they have now done with our encouragement on memory chips, then the prices are higher.

REPRESENTATIVE HAMILTON. As you look ahead, do you think we are going to have a lot more friction with Japan on economic questions in the next few

years than in the past few years? Is it going to become a larger question for us, or less so?

MR. LINCOLN. I would guess that it would remain about the same. It is a little hard to imagine that the degree of intensity in bilateral negotiations being worse than it has been in the past five or six years.

REPRESENTATIVE HAMILTON. What about Mr. Aho's statement a moment ago, that he thinks there are going to be more tensions and frictions with the European Community than with Japan. Would you agree with that?

MR. LINCOLN. That is a possibility, yes.

REPRESENTATIVE HAMILTON. It is obviously a possibility. Is it going to be a fact?

MR. LINCOLN. I guess I would be inclined to say, no. I think that—

REPRESENTATIVE HAMILTON. You worry more about Japan than you would the European Community?

MR. LINCOLN. At the present time, yes. Partly because I think the issues with the EC generally are fairly clear. We know what the problem is. It is a little bit easier to sit down and talk about it. With the Japanese, often the problems have been rather opaque, and I think that is one of the reasons why they tend to become more tense.

REPRESENTATIVE HAMILTON. Mr. Aho, you wanted to comment on some of this?

MR. AHO. Yes. First, about the EC, it is government-to-government problems we will have with the EC. I mean, Japan and the United States are doing very well in Europe competitively, but it is getting the European Community to engage with us on trade liberalization, on multilateral initiatives. They are the frustrating foot-draggers. That is what I would say there.

REPRESENTATIVE HAMILTON. What do you say to the person out in Indiana who thinks Japan is ten feet tall? What do you say to them?

MR. AHO. I don't think they are ten feet tall, but they are doing right now what it will take for them to be a stronger competitor than us in the decades ahead. They are investing more, and their education system is much better than ours. I would like Japan to be more open. We have to get greater access for investment and stuff like that, but what Japan is doing is exposing our weaknesses, and that is what we have seen over the years on education and investment and savings and all that.

REPRESENTATIVE HAMILTON. Let's pick up on that for a minute. Do all of you think that unless we change our ways, then Japan is going to continue to get stronger and stronger as an economy, and we are going to continue, at least in comparison, to get weaker and weaker? In other words, are the present trends deeply disturbing? Do you all agree with that?

MR. FALLOWS. Yes.

MR. LINCOLN. Yes.

MR. AHO. Yes.

REPRESENTATIVE HAMILTON. I didn't mean to interrupt you.

MR. AHO. Well, to Jim Fallows, maybe earlier I didn't say it, but primarily homegrown. They aren't totally homegrown. On Ed Lincoln's win-win, that we could both benefit, clearly if we were to retrench and start putting things

up at the border and stuff like that, we both lose. So I would prefer that we get our act together at home, and hopefully open up Japan and encourage an expansion of trade and investment, rather than the contraction.

REPRESENTATIVE HAMILTON. Well, I certainly have more questions. I will turn to Senator Bingaman here. Go ahead, Senator.

SENATOR BINGAMAN. Thank you very much. Let me be the devil's advocate for a minute on this general question that the chairman was raising. There are some who make the argument pretty strongly that even if we do all of this that we are supposed to do in order to meet this challenge that you folks generally have prescribed here, we start investing more, we start saving more, we start educating our children, we start retraining our workers, we start doing all of this stuff, we still are going to, relative to Japan, be falling behind in future decades because of the way they structure themselves.

Keiretsu, or whatever you want to call the combination of ways that they organize themselves, makes it impossible for a Japanese firm to fail. There is no danger that Mitsubishi or Hitachi or any of the major Japanese corporations are in economic difficulty, or going to be in economic difficulty, in a serious way. They may have to make some changes in their plans, but they are not subject to the same competitive pressures that U.S. firms are or that European firms are in most cases. So, when you talk about how we should restructure our international economic relations, the argument is that in addition to doing all these other things, which the Protestant ethic would encourage us to do, working harder and doing better and learning more and all of that, we need to also come to grips with the fact that there have to be some different rules for a country that organizes itself like Japan. You cannot continue to assume that we can compete on a reasonable basis with that arrangement if we are organized the way we are and they are organized the way they are. I would be interested in any reaction to that, Mr. Fallows.

MR. FALLOWS. I think the threshold point here is the necessary but not sufficient concept, which we all agree with, that there are certain necessary steps—the budget deficit, you know the next 100 items on that list. The question, therefore, is whether that is sufficient. Our economic orthodoxy tells us that it should be sufficient, that economics systems should behave the same around the world and that we would always end up losing if we did things beyond that, like interfering with tariffs, having government intervene in industrial policy. That is what the theory we have all learned tells us.

What the history of major economies, including ours, seems to teach is that that is not necessarily so, that the Japanese, Koreans and Taiwanese have, in the last 40 years, deliberately sheltered certain industries from foreign competition. They found ways to generate domestic competition. Those industries are better off now.

The United States did the same thing in the 19th century, and has done it in this century with aircraft and with other industries. My own view is that our problem is that of economic orthodoxy, that what we have told ourselves for the last 40 years about the world is not historically borne out, and that the necessary steps will not by themselves be sufficient. Other interventions will be necessary.

SENATOR BINGAMAN. Mr. Lincoln, do you agree or disagree with that?

MR. LINCOLN. By and large I disagree with the notion that we need a special set of rules or, say, a special set of protectionism aimed at Japan. Let's take something like the keiretsu, which represents a different form of interaction among companies than we normally have in the United States.

For example, if we look at one particular form of the so-called vertical keiretsu, the relationship between the buyers and supplies, between Toyota and its parts suppliers, if, in fact, they are doing something that we perceive as being wrong, we have every right to attack them under existing antitrust policy. If, in fact, they are doing something that is more efficient than what we are doing, why should we punish them? And, in fact, I think we are now seeing in American industry, where the desirable features represented by these relationships are being adopted by at least some of our leading companies, a greater attention to those relationships.

SENATOR BINGAMAN. Let me bring it down to a real specific. This was a conversation I had with one of the vice ministers at MITI when I was there in January. To try and stimulate discussion with him, I said, it seems to me that there are some of these high-tech industries that are developing where the United States is going to be totally shut out. I mean, for all practical purposes, we do not have any significant domestic capability to produce flat-panel displays. We are dependent upon Japan or perhaps other countries in the future, but essentially we are dependent upon Japan. Wouldn't it make sense for the United States to adopt an infant industrial policy with regard to the flat-panel display industry, and use the very same techniques that Japan used for decades in dealing with us. That is, force cross-licensing of technology and put up protective tariffs, subsidize the domestic industry, give exemptions to the antitrust laws, do whatever we need to do to develop that capability. Otherwise, we are going to be shut out of the flat-panel display industry. His reaction was that that is exactly what we ought to do. That is what the Japanese have done. It is permitted under GATT, and it is exactly the kind of action that the United States should be taking if it wants to be a player in high technology products in the future. What is your reaction? Do you agree with that?

MR. LINCOLN. I would agree with that, by and large. I wouldn't call that an exception to the rules, made because Japan is different. I think it is intelligent, domestic policy. Ding.

SENATOR BINGAMAN. It is certainly an exception to the way we have done business in this country.

MR. LINCOLN. It is an alteration of the way we have done business in the past, right, but it is not one that would single out a policy toward Japan that was different from policy toward other countries. There are things I would do and wouldn't do. I would be more inclined to provide some kind of subsidy or other incentive to help the industry get started rather than putting up protectionist barriers to keep other products out.

SENATOR BINGAMAN. But you see, there is such an investment by the major Japanese firms that are engaged in production of flat-panel displays that there is no way you can get a U.S. firm to make any kind of investment unless it can be assured of some market. Unless you put up some kind of protection of our market, once there is an American product to be purchased—which there is none—there is no way to get U.S. industry involved. That is why I think no U.S. firm has stepped up and said, okay, we are going to get in there and try to

go toe-to-toe with the Japanese in this area. We are starting way, way behind the pack, and the pack is exclusively Japanese.

MR. LINCOLN. That is part of the problem. I think a successful domestic policy is not one in which we would say, oh, gee, the Japanese now have a flat-panel display industry that is very efficient. We better have one ourselves. It would be a policy in which we would have recognized ten years ago, that this was the coming new technology, and we should be putting an equal amount of resources into it, which we see with Japan and other countries.

Now, the dilemma with that is that we can all get into a bidding war of dumping money on our industries to see to it that each one of us is the leader, which comes back, I think, to a point that Mike Aho made earlier, that if we are going to do this kind of thing, we need stronger multilateral institutions to set some rules for what we think is acceptable. At the moment we have no rules, and the Japanese do it and we don't do it, and we get irritated by it. We need to fold it into a multilateral setting.

SENATOR BINGAMAN. Mr. Aho, did you have a comment?

MR. AHO. I agree with everything that Ed said. We do have to ask ourselves, especially with performance in recent years, are our rules wrong? Pardon the confusion of two different languages or cultures here, but has the laissez-faire, Anglo Saxon approach, hands-off approach to economic policy outlived its usefulness? Do we really need to change rules? Do we need to go back and look at those fire walls that were created in the 1930s between the financial industry and the individual real producers?

We have to take a hard look at that stuff. I don't think we can mimic Japan, but we could make an awful lot of improvements where we are crippling ourselves with our own rules and regulations, which are now outmoded, and we may have to do some subsidies. The problem is, which industries do we pick. We now know that we should have picked what you were suggesting, but what do we pick for the year 2000 to try and champion? That is a little bit harder thing to do, but we probably have to get on with it.

REPRESENTATIVE HAMILTON. Let me just ask a few questions with respect to Japan's role in multilateral institutions. Do you believe that we are at a point now where Japan's role in the international organizations ought to be increased? I am speaking now, of course, of the United Nations and GATT and IMF and all of these institutions?

They were structured basically after World War II, and there have been dramatic changes since then. Would you all be in favor of enhancing Japan's role in those institutions, to be commensurate with their economic power? Would there be any objection to that?

MR. FALLOWS. To me it seems both, number one, inevitable and number two, desirable. The desirability is that it will mean a relative reduction of U.S. power, but I think that would be offset by the normalization of Japan. The more that can be built into having an international role rather than a strange insular role, the better, I think.

REPRESENTATIVE HAMILTON. You agree, the rest of you? And if that happens, what does it mean for the international institutions? I mean, will we then get changes in those institutions? How would Japan's increased role tilt the organization?

MR. LINCOLN. Let me start by saying, I think that to some extent Japan's role has already increased. Their voting rights in the World Bank and IMF have risen. The sad thing to me is that involvement can take many forms, and the Japanese have argued over voting rights or permanent membership on the Security Council. In fact, one of the problems we have at the present time is that there has been an extremely low personnel involvement by the Japanese in these organizations. Roughly 1 percent in all of these—the IMF, the World Bank.

REPRESENTATIVE HAMILTON. Why is that?

MR. LINCOLN. Mainly because the Japanese were domestically focused, as Mr. Fallows said earlier. They were not interested in participating in world affairs. They didn't see the need to send people. People didn't want to—

REPRESENTATIVE HAMILTON. They are not being excluded? They are not—

MR. LINCOLN. They are not being excluded. They are generally below their informal or formal quotas in all of those organizations.

REPRESENTATIVE HAMILTON. Do you think U.S. interests are going to be hurt in any specific way if Japan's role is enlarged?

MR. LINCOLN. I don't think so. It depends, I suppose, partly on what role Japan chose to play. To give you an example, I think it has been of tremendous value that the current U.N. high commissioner for refugees is Japanese, a very outspoken and outgoing woman who, I think, is doing wonders in Japan, playing a public relations role in Japan to get people aware of the value of participating in an important function of the U.N.

REPRESENTATIVE HAMILTON. Let me get your sense of evaluation of the various kinds of tactics we have used in dealing with Japan. We have had the Tokyo round, we have had sectorial talks on things like telecommunications, semiconductors. We have had the Section 301. We have had these structural impediment initiatives. We are constantly using new approaches. Give me an overall evaluation of how you think these approaches have worked. Are we on the right track, or do we need to fairly dramatically change our approach to Japan? Anybody.

MR. AHO. I would say some of this has been creative toolmaking or policy-making over time, in part to diffuse political pressures back in this country, that we find a forum like the SII talks to do something in order to address these things, but they have turned out to be successful by and large. I think we have prodded progress with things like 301.

REPRESENTATIVE HAMILTON. Mr. Lincoln says continue pressure for access. I gather from that statement that you think the present strategy we have had is the right one. Do you agree with that?

MR. AHO. Yes.

REPRESENTATIVE HAMILTON. Keep putting the pressure on them, open up those markets, and they respond? That is the way to go. Do you agree with that, Mr. Fallows?

MR. FALLOWS. I mainly disagree. My point would be that they have been successful in a way. As Mr. Lincoln was pointing out, there are tangible, though often modest, results of each specific pressure point. The way they have been a failure has been by the standards of what we thought we were doing.

Generally, the American idea in each round has been that this will be it. We will get rid of the tariffs, then things will be over. We will get rid of the retail laws, then things will be open. So there has been this constant intellectual expectation that we are going to convert their economy into one like ours. So I think we should have the continuing specific pressure, but drop the illusion that it is going to transform the economy there.

REPRESENTATIVE HAMILTON. How do you feel about things like Section 301 and those things?

MR. FALLOWS. I think the moralistic overtone that goes with it is bad. If it could be done in a less moralistic way and, say, we have certain problems here, we are going to automatically kick in provisions when these problems come, then I think that would be good. I don't like the moralism of it.

REPRESENTATIVE HAMILTON. You like the idea of the structural impediment initiative?

MR. FALLOWS. No, I didn't like that. It seemed like a missionary project, like we were going to bring Christianity to them, and its overall purpose I think was wrong.

REPRESENTATIVE HAMILTON. You favored that, structural impediment initiatives, right?

MR. LINCOLN. Not so much for the things that it accomplished. I saw it mainly as an educational tool, that it brought U.S. Government officials, who had not previously thought in a serious way about the Japanese economy, into position where they had to learn something and perhaps deal with Japan more realistically because of that.

REPRESENTATIVE HAMILTON. You would favor it continuing?

MR. LINCOLN. I don't think it is doing any great harm. One of the nice things about the SII—

REPRESENTATIVE HAMILTON. Would you drop them, Mr. Fallows?

MR. FALLOWS. I suppose I would keep them going on a low level, but without a big rhetorical emphasis.

REPRESENTATIVE HAMILTON. Excuse me.

MR. LINCOLN. I was just going to say that we structured it in a way that the Japanese could complain about us, too, and that, I think, was important. There is a matter of diplomacy involved, and one of the things that the Japanese get upset about is that we spend all our time beating up on them.

REPRESENTATIVE HAMILTON. Is it your impression that they are tougher negotiators than we are on trade issues? I have heard the complaint, for example, that we have such rapid turnover of trade negotiators that they sit down and have to get reeducated themselves. The Japanese have more persistence and more staying power and more structure.

MR. LINCOLN. They put more effort into it. We have had many negotiations where the U.S. side walks in with three or four people, and the Japanese will come in with 50 or 60, but, no, in terms of personnel. In fact, I think we could argue that over the past decade, we have had more consistency in personnel in negotiating directly with Japan than the Japanese have had with us. Their people rotate every two or three years.

REPRESENTATIVE HAMILTON. You don't have the sense that they outbargain us?

MR. LINCOLN. I guess I am not in a position to really——

REPRESENTATIVE HAMILTON. Mr. Aho, how do you feel about that?

MR. AHO. I think I would agree with Ed. We have gotten better, and SII did help. It was an educational effort. The exposure there was quite good.

REPRESENTATIVE HAMILTON. Good both ways?

MR. AHO. Yes, because it was reciprocal. They were trying to tell us what was wrong with us, and it was that listing of competitiveness indicators that I mentioned before, but the story is told that Kuroda, who was the former Vice Minister of MITI, was at a dinner party in Cambridge, Massachusetts, and was introduced this way in 1986: Corroda-san graduated from Tokyo University in 1956 and he entered MITI. He has been there ever since. There is no, you know, long list of all these other positions that he moved in and out. He moved around in MITI, but he was there and was a darn tough negotiator the entire time.

REPRESENTATIVE HAMILTON. Okay. Now, how about this distribution system that we hear so much about, are the barriers of this distribution system very formidable for us, and how much can we help the U.S. producer here on the distribution system?

Mr. Lincoln, Mr. Fallows, you have lived there. You must have some direct experience with it. What have you got to say about it?

MR. LINCOLN. There are two kinds of problems—one that is a problem and one that is not. The one that is not a problem is complexity. A lot of times you hear that it is a very arcane system, that it is difficult for foreigners to understand. That is not a problem. The real problem in distribution in Japan is that large manufacturers can control, to a much greater extent than American manufacturers can, the distribution of their products and the pricing of those products. That is something that I think requires U.S. Government pressure.

REPRESENTATIVE HAMILTON. Excuse the interruption. I was just notified that I have to go to the Floor for a bill that is pending, so I am going to have to leave you. I will turn it over to Senator Bingaman. I think he has a few minutes, at least. I want to say to you how much I appreciate your appearance this morning. It is good to have you. It is good for us to be able to draw on your experience and your expertise. I actually have a good many other questions that I would like to visit with you about, but as often happens here, time runs out for us. Thank you very much. It is nice to see all of you.

SENATOR BINGAMAN. [Presiding.] Let me just ask a few more questions, then we will let everybody out of here. Where do you folks see the trade deficit going? I know we talk about keeping the pressure on. We try this, we try that, we try something else.

As best I can determine, the trade deficit is on the increase. It is growing. Our trade deficit with Japan, particularly trade deficit in high technology products, continues to be enormous. I don't see that changing. Maybe it will change very slightly. I know we have this effort to do better in semiconductors, but I guess the target, which Kuroda denies having agreed to 20 percent, is now at about 14 percent, I guess, and the 20 percent is supposed to be reached by the end of the year, and everybody is well aware that it won't be.

Where do we go with this trade relationship? Can you continue another decade with a major trade deficit with Japan? I mean, at some stage, don't we have to take some fairly radical action to deal with that, Mr. Fallows?

MR. FALLOWS. My view would be first, in the short term, a trade deficit is clearly going up, and I think the main reason seems to be the recession in Japan, which is slowing down their imports, and that is what is driving it in the short term.

In the long term, the trade deficit may correct itself somewhat, but that may not solve our problems. There are various ways for us to reduce the trade deficit by exporting more raw materials, or by having more assembly plants in the United States. I think that, as you well know, the underlying economic and technological imbalance is the one that doesn't seem to be correcting itself at all, and so I think that we should keep public attention on these underlying imbalances rather than on the trade number, which can go up and down for reasons really not connected to our fundamental strength or theirs.

MR. LINCOLN. I would largely agree with that. We are going to see a deterioration this year. We are coming out of recession. The Japanese are slowing down. Their overall imports have been falling for a number of months now. That is going to make things get worse for cyclical reasons that have nothing to do with long-term structural problems. The trade imbalance in and of itself has no meaning. Any and all economists will say that.

What it does mean, though, I think, perhaps, in the sense that Mr. Fallows meant it, is that it is an indicator to us of how are we doing competitively vis-a-vis the Japanese, and if that is how we want to interpret it, then, yes, we should see it as a sign of some concern.

Frankly, I guess, I would argue that Japan's trade surplus with the world, at least, will go down over the course of this decade for reasons, again, that have nothing to do with competitiveness, but have to do with savings and investment balances. Japan is aging at a very rapid rate, perhaps even as rapidly or more rapidly than Germany. This is altering the balance of savings and investment, and will bring down their surplus with the world, but that still may leave us with a large deficit on high technology items.

SENATOR BINGAMAN. Mr. Aho.

MR. AHO. I think the other thing here, we may actually end up consuming more goods with Japanese names, but we may be importing them from Mexico, Singapore and Taiwan, so the bilateral deficit actually could improve ten years from now, but we will have a lot of Japanese products that we are buying back here.

MR. LINCOLN. That, by the way, is now an announced policy by MITI to encourage investment in Southeast Asia so that the bilateral trade deficit with the United States will go down.

SENATOR BINGAMAN. This business about the Asian economic zone, that has happened to a very large extent already, has it not? U.S. industry is dramatically outgunned by Japanese industry in most of Asia as far as investment levels, presence and penetration of those markets. Am I wrong about that? That has been my impression.

MR. LINCOLN. That is not entirely clear. In terms of the imports of Asian countries, they import only slightly more from Japan than they do from the

United States at the present time, and that has been roughly true with very little change in the percentages coming from either one of us for the past 15 years.

In terms of investment, investment data is not very good, but the best one could say, I guess, is that in the mid-1980s generally, the level of the stock of investment from Japan and the United States was more or less equal in Asia, varying from country to country. The big change has been over the last five or six years in which there has been a surge of Japanese investment and there has not been a surge in U.S. investment. We have added somewhat to our stock there, but the Japanese have moved in dramatically.

It is, perhaps, a more visible difference because Japanese investment has often been in consumer items, and ours has been in areas like oil development, which doesn't show up on the streets of these countries. So there is certainly a sense that the Japanese are more deeply embedded in the daily lives of people in these countries.

SENATOR BINGAMAN. Everyone agree with that basically?

MR. FALLOWS. My impression is that this does vary country-by-country, but in some of the fastest growing and most technologically advanced Asian countries—I am thinking of Korea and Taiwan, and then down the list, Thailand and Malaysia—they are increasingly oriented towards Japan and the supplies of technology and investment and, in a larger sense, of being integrated into the Japanese model.

As Mr. Lincoln was saying, there are various offsetting U.S. presence there, especially in the oil industry and in many capital goods industries. But my impression is that the momentum is clearly in the direction of being centered on Japan.

SENATOR BINGAMAN. Once again, to ask about this semiconductor thing, is there anything that any of you recommend that could be done to do a better job in penetrating the Japanese semiconductor market by U.S. semiconductors? I mean, it seems to me that when you look at U.S. industries, industrial groups, our semiconductor manufacturers have done a better job than virtually any other as a group trying to get into that market. They have very competitive products. They have improved their quality dramatically in the last decade. They have made very aggressive efforts, as far as I can determine, to try and get access to that market. They still are at 14 percent there; whereas, they are at 50 percent in Europe and 70 percent here.

Is there anything more that they could do or that the U.S. Government could do to assist them? Do you just accept the fact that we are going to, for most intents and purposes, be shut out there? I mean not shut out. The reason I think it is important, I hadn't realized before this last trip to Japan that something like 40 percent of the semiconductors consumed in the world are consumed in Japan, 28 percent in this country, so that is the market. That is by far the largest market for semiconductor products. That is why they are so intent upon trying to gain market share.

MR. FALLOWS. Without being an expert in this field, my feeling would be that if we assume it is going to happen simply by these quality control-type measures, then it is not going to happen, and that we need not be shut out there permanently. But it is a matter of the ham-handed negotiations that we have had before, saying okay, it is 20 percent.

I think the way to get 14 percent is to say 20 percent, and the way to get 20 is to say 30, but not to just say we will try hard because that will not lead to a change.

MR. LINCOLN. This is a particular industry where the Japanese many years ago chose to behave in a very protectionist fashion, embedded the semiconductor industry in a set of very tight keiretsu relationships, and was very resistant to the outside as a matter of national policy.

Frankly, I think this was an area where we have come down to doing the only thing that would work, and that was to argue about market share. I don't like setting market shares, but this was a case in which it seems to me that there was no other choice, so I think we have to live with that as an undesirable but necessary way of dealing with this issue.

SENATOR BINGAMAN. MR. AHO.

MR. AHO. I would agree with that.

SENATOR BINGAMAN. Why don't we stop with that. I appreciate very much the testimony. I think it has been a very good hearing.

[Whereupon, at 11:35 a.m., the Committee adjourned, subject to the call of the Chair.]

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