

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

The US and Japan: Beyond Bilateralism

by TJ Pempel, University of California at Berkeley

For most of the period following the signing of the San Francisco Peace Treaty in 1951, relations between Japan and the United States were predominantly bilateral. The two governments shared policy goals and dominated policy developments. The relationships with each other dominated Japanese foreign policy overall and American policy in Asia.

But starting in the mid-to-late 1980s and accelerating since then, once unambiguously bilateral ties have become far more complex and consequently ambiguous in character. Three forces have driven these changes: 1) alterations in geopolitics, 2) the enhanced role of private capital flows, and 3) the rise in number and importance of multi-lateral organizations.

Shared Goals: From the end of the US Occupation, Japan and the US shared the same side in the bipolar international arena, including an unmistakable

commitment to the military containment of USSR, China and other communist regimes in Asia. Closely linked to this military goal were intimate economic relations even as both pursued distinctive but compatible versions of capitalism.

In the bipolar world that prevailed until the collapse of the USSR in 1989, Japan was America's single most important anti-communist ally in Asia and integral to what has been described as "America's grand crescent of communist containment" — military bases that stretched from the Aleutian Islands through Japan, South Korea, Taiwan and the Philippines south and on to Southeast Asia, ending in New Zealand and Australia.¹

Japan relied without question on US military force, including the so-called nuclear umbrella, as the primary component of its own defense policies. This included the stationing of large numbers of American troops on Japanese soil. Japan had no military alliance arrangements with any country other than the US, and while the US had numerous alliances throughout the world, in Asia, all of its ties were based on bilateral ties, rather than on multi-member alliance structures such as NATO. The single most

important of these was its alliance with Japan.

Predicated on these American guarantees of Japan's security and access to US markets, Japan pursued a systematic strategy of rapid economic development at home and a low posture abroad in areas both diplomatic and military. From direct economic assistance in the early postwar years and continuing on to a disproportionately low value for the yen, low cost technology transfers, and a disproportionately open market for Japanese exports through much of the 1970s and into the 1980s, the US provided Japan with widespread economic assistance calculated to assist Japan in becoming an economic success story that could be projected as a model for Asian and other development.

Bilateral Institutions. Beyond shared goals, bilateral institutional mechanisms formed a second important feature of the relationship. The executive branches in both countries dominated this process—in the US it was primarily State, Defense and later the USTR; in Japan, the Ministries of Foreign Affairs (MOFA), International Affairs and Industry (MITI) and Finance (MOF), and periodically,

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the Japan Defense Agency (JDA).ⁱⁱ Rarely did actors other than the two governments' official agencies exert more than marginal influence over policymaking. Particularly limited in their influence were Japanese parliamentarians and the US Congress.

In contrast, ties between the US and its Western European allies were embedding in a series of multilateral organizations, including NATO, the European Coal and Steel Community and eventually the EU. Such multilateral organizations gave European allies a series of formats within which to forge temporary alliances on specific issues or to bundle issues and engage in trade-offs from one issue to another.

Non-Linkage. A third feature of the bilateral relationship involved the functional separation of issues, particularly those of security and economics. In the aftermath of the 1960 Security Treaty crisis, a succession of Japanese governments worked diligently to ensure that any popular Japanese frustrations with the military aspects of the treaty not interfere with the country's focus on high-speed growth. US defense and foreign policy establishments did their best to keep issues of economics subordinate to security.

Institutional arrangements facilitated this separation: institutions

“Starting in the mid-to-late 1980s and accelerating since then, once ambiguously bilateral ties between the US and Japan have become far more complex, due in large part to three driving forces: alterations in geopolitics, the enhanced role of private capital flows, and the rise in multilateral organizations.”

devoted to military problems did not deal with trade; monetary issues were dealt with along still a separate track. Similarly separated were environmental, cultural, and foreign aid issues. Functionally specific agencies in both countries worked with one another on such matters relatively independently of issue linkages. On the relatively rare occasions when broader coordination was necessary, the White House or the Prime Minister's Office became the ultimate fulcrum on which the relationship hinged.

Although the US-Japan relationship was bilateral it was also asymmetrical. The US has always possessed vastly more military and economic resources than Japan and its foreign policy goals are global, not regional. For the most part, Japan, even after its GNP became the second largest in the world, remained at best a regional power. Under bilateralism, Japan was typically dependent on the US and locked into a complex and embedding relationship. Despite polite fictions about joint consultation, the US had a relatively free

hand in the use of its troops in Asia. Moreover, the US was committed to defend Japan although Japan had no reciprocal responsibility.

For decades, economic, trade and investment relations were also bilateral and unequal. Not until the US began to experience domestic economic problems did it begin to press Japan to alter its economic policies. The key turning point came in the early 1970s when the US went from the world's largest creditor nation to its largest debtor. Conversely, Japan began to experience a major shift in its international balance of payments that peaked in 1993 at nearly \$132 billion.ⁱⁱⁱ Throughout the 1970s and 1980s, the size of the Japanese bilateral trade surplus was a huge and growing irritant.

By the late 1980s and early 1990s, this relatively harmonious bilateral relationship ran headlong into three complicating challenges: changes in geo-politics, changes in global capital flows, and the increasing importance of multilateral organiza-

tions. The nature of the bilateral relationship began to change.

Geopolitics. Bilateralism had been based on an Asia-Pacific in which the security tableau was simplistically clear. Japan was far and away the richest and most industrially developed democracy in Asia, making it a very logical anchor for US policies in the region. When the Cold War ended and the overt threat of nuclear war was reduced the bipolar clarity that had allowed the US and its allies to demarcate 'friend' and 'foe' disappeared as well. Within Asia, new and potential conflicts centered on intra-state conflicts, particularly those involving religious or ethnic splits, and subsequently on non-state terror.

The increased economic well-being and democratization of several other Asian powers, most particularly South Korea and Taiwan, and to some extent Thailand, the Philippines and Malaysia, also complicated bilateralism. Japan was no longer the sole outpost of industrialization and democratization in the region. The security community, meanwhile, has been developing through a variety of new multilateral forums such as the ASEAN Regional Forum (ARF), the Six Party talks and Track II dialogues.

Also undercutting past security certainties has been the heady

economic growth and expanded military capability of China. China's leaders began the tentative embrace of more pro-Western and capitalist-friendly policies, thereby contributing to an improved regional security climate and opening the way to a host of previously implausible diplomatic and economic ties between China and its non-communist neighbors. China's influence in the region, as well as over US-Japan ties, has skyrocketed. But uncertainties about Chinese intentions and the potentially competitive impact of Chinese economic growth remain high.

Both US and Japanese policy-makers have expressed varying

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concerns about the potential security rival and economic threat posed by China's rapid economic liberalization and growth. President Clinton's policy of "strategic engagement" with China paralleled by diminished economic interest in Japan enhanced worries among Japanese policymakers about so-called "Japan passing" in which the US no longer felt any particular

necessity to approach Asia through Japan; it could instead deal directly with other Asian countries, particularly China. The current result is a trilateral relationship – US unilateralism pushes Japan and China closer together while any warming of ties between either Japan or China on the one hand and the US on the other, forces a recalibration of interests by the party left out.

In today's post - September 11 world, Asia now represents not a bipolar map defined largely by armies and alliances, but rather a vastly more complex tableau marked by intensified national concerns over economic security as well as over military security, a

region in which military issues are no longer defined in clearly bipolar terms, and a region with far more multipolarity than at any other time in the last hundred years.

Global Capital Flows. Since the early 1980s, there has been an explosive increase in the amount of capital moving across national

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borders. By far the largest proportion of these capital movements is private, not governmental, thereby limiting prior powers of national governments to shape monetary policies.

Expanding flows of private capital have had a major impact on both the Japanese and American political economies, enhancing the choices of private capital holders, reducing government control, and reshaping the nature of the US-Japan bilateral relationship. Most fundamentally, they have sparked a series of closer economic ties across the region, making the Japanese economy far more regional than it was previously. For the US such changes meant an explosion of influence by investment banks, bond rating agencies, mutual fund managers, and multinational investors.

Internationalization generally has combined with important liberalizations of Japan's domestic currency regime to erode many of the economic foundations that previously underpinned "Japan, Inc." The ability of Japanese government officials and the Bank of Japan to set exchange rates has diminished while the power of international markets and currency speculators and the significance of global finance over US-Japan relations have risen sharply.

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Also affected has been Japanese outward investment. This exploded in Asia, generating a twofold shift in Japanese foreign economic policy. First, foreign direct investment and globalized production networks began to outweigh simple production and trade from the home islands. And second, Asia gained in importance within the corporate strategies of numerous Japanese-owned companies.

Although many Japanese-owned companies remained international export powerhouses, their products were no longer manufactured exclusively or even predominantly within Japan. Indeed, by 1995, Japan was manufacturing more overseas (¥41.2 trillion) than it was exporting from the home islands (¥39.6 trillion).^{iv}

Movements by Japanese money into Asia contributed to a bottom-up process of economic regionalization. The various national economies of Asia became increasingly interlinked. Similarly, intra-Asian trade expanded considerably. Japanese exports to the rest of Asia rose from 25.7 percent in 1980 to 42.1 percent in 1995; by this time,

for the first time in decades, Japanese exports to Asia were greater than to the US. By 2002 China had replaced the US and Japan's number one trading partner.

Increased competition and accelerated global capital flows gave rise to two phenomena in the 1990s: (1) demands for reforms in Japanese corporate, accounting and financial practices (many of which have been strongly resisted by domestic Japanese political and corporate policymakers), and (2) a flow of money into equities and foreign exchange speculation in Asia, further catalyzing regional growth and interconnectedness. Equally importantly, however, much of this money was quick to flow out at the first signs of exchange rate instability; it was a major source of the currency and market collapses of several Asian countries in 1997-98.^v

But in the aftermath of the Asian economic crisis of 1997-98 and as a result of Japan's own slow economic adjustment, Japan's prior economic predominance within Asia has been shrinking, further diluting the

preeminence of bilateralism between the US and Japan.

Increasing Multilateralism. As noted, postwar American policies were quite different toward Europe and Asia. Interactions in Europe were largely multilateral, whereas in Asia, US policy was built around a series of parallel bilateral alliances. Even in the economic arena, Asian multilateralism was far slower to evolve than in several other parts of the world.

Indeed, the US strongly resisted any Asian regional proposals that suggested Asian exclusivity at the expense of US inclusion. Even APEC generated initial ambivalence by the US; it wasn't until the 1994 launch of NAFTA that Washington began to show real interest in APEC and this has waxed and waned.

The US has been even more resistant to Asian multilateral organizations aimed at security. Only with the arrival of the Clinton Administration did the US commit itself to

the development of multilateral forums for security consultation as one of ten major goals for US policy in the Asia-Pacific. And the US commitment was to "forums for consultation" rather than a full embrace of multilateral security institutions.

Japan has historically been far more receptive to multilateralism and working within the various international organizations than has the US. But the persistence of bilateralism left Japanese officials in a far weaker bargaining position than their US counterparts, particularly on trade issues. Thus, after the many trade frictions of the mid-to late-1980s, Japan was anxious to reduce its dependence on the US and also on those global multilateral organizations where US influence was overwhelming.

As a consequence, Japan became increasingly proactive in fostering regional organizations on a host of problems. Multilateralism in Asia offered Japan with a way to reassert

enhanced regional influence in ways far less threatening than any unilateral steps might have been. Japan was consequently an early and strong supporter of the Asian Development Bank, the ASEAN Regional Forum (ARF), the Asia-Pacific Economic Cooperation forum and a host of informal, non-official institutions such as the Pacific Economic Cooperation Council (PECC), the Pacific Basin Economic Council (PBEC), and the Pacific Trade and Development Conference (PAFTAD) all of which helped lead to APEC's formation, as well as dozens, if not hundreds, of so-called "track two" dialogue processes.

Furthermore, the downside of its bilateral security relationship with the US was made clear to Japan in the first Bush Administration's deeply critical reaction to Japan's behavior in the Gulf War. While Japan tried to earn alliance credit

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- ⁱ Bruce Cumings, *Paradox Visions: Making Sense of American-East Asian Relations at the End of the Century* (Durham, Duke University Press, 1999).
- ⁱⁱ Destler, Fukui and Sato, *The Textile Wrangle*; Atsushi Kusano, *Nichi—Bei: Massatsu no Kozo*; Hideo Ôtake, *Gendai Nihon no Seiji Kenryoku Keizai Kenryoku* [Political and Economic Power in Contemporary Japan] (Tokyo: San'ichi Shobo, 1979); Akio Watanabe, (ed.) *Sengo Nihon no Taigain Seisaku* [Postwar Japanese Foreign Policy] (Tokyo: Yuhikaku, 1985), inter alia.
- ⁱⁱⁱ Edward J. Lincoln, *Japan: Facing Economic Maturity*. (Washington, D.C.: Brookings, 1988), p. 4.
- ^{iv} *Far Eastern Economic Review*, July 4, 1996, p.45.
- ^v T.J. Pempel (ed.) *The Politics of the Asian Economic Crisis* (Ithaca: Cornell University Press, 1999), esp. Chaps. 2-5. Stephan Haggard, *The Political Economy of the Asian Financial Crisis* (Washington, D.C. Institute of International Economics, 2001).
- ^{vi} Michael J. Green, "The Challenges of Managing U.S.-Japan Security Relations after the Cold War," in Curtis *New Perspectives*, p. 244.
- ^{vii} Michael J. Green, *Japan's Reluctant Realism: Foreign Policy Challenges in an Era of Uncertain Power.*, (New York: Palgrave, 2001), p. 193.

The Weak Case of Linking Chinese Demand And Japanese Deflation

by Naoki Tanaka, The 21st Century Public Policy Institute

In its March 13 statement of Japan's domestic corporate goods price index for March, the Bank of Japan reported that commodity prices rose 0.2 percent over the same month the previous year. This development marked an advance into positive territory — the first time in nearly four years.

Many economists expressed relief, believing that Japan is finally seeing an end to the struggle to vanquish deflation. They argue Japan's domestic corporate goods price index is being driven by Chinese demand for many products, especially basic materials, which has boosted prices for iron ore, steel materials, petrochemicals.

But this explanation is too facile. Each discrete unit of commodity prices must be examined. The commodity-price index is only a composite value comprised of various items, including both appreciated and depreciated items. In order to measure the strength of the linkage between surging Chinese demand and easing Japanese deflation, detailed examinations should be made on changes of price index item by item.

To thoroughly examine the statistics, I divided the 1,300 products that comprise the corporate goods price index into ten increments of 10 percent each based on the amount that each product's price

has changed from the same-month period in the previous year (the top segment covers products whose prices showed the greatest appreciation vis-à-vis the prior). I then assigned values to each, and took the 130th product from each segment in order to analyze its price shift over the twelve-month period.

I then applied this approach to the products that comprise the Bank of Japan's corporate goods price index — i.e. assigning values to each product in the most-appreciated category, beginning with the product that showed the highest rise within that category, down to the product that showed the lowest. Selecting the product that falls exactly on the top-10 percent line (the 130th of 1,300 products), a price appreciation of approximately 5 percent from the same-month period in previous year has been maintained since spring 2003.

Thus, this product can be considered to have reached a plateau. A look at products that have recently been positioned on this top-10 percent line (the products whose degrees of appreciation were at exactly the top-10 percent mark overall) shows that there has recently been an appreciation of slightly more than five percent in the prices of products occupying that position. Since the five percent

appreciation level was reached early last spring, it zigzagged around that level for some time, and has recently resumed an upward trajectory.

In light of this, the phenomenon by which commodity prices in the rest of the world were pushed upward by the surge in demand from China only got its start in the fall of last year when scrap iron prices and charter ship prices began to rise significantly. Looking only at the top-10 percent line, it would seem that Japan's prices have been largely stable since early spring 2003. And some items did appreciate significantly. For example, steel prices have been boosted far more than those of top-10 percent line products. Steel, therefore, can be classified into a group of items strongly influenced by surging Chinese demand.

But if consideration is narrowed to the 10 percent-appreciation line, it is clear that prices reached a plateau at the five percent appreciation level compared to the year prior. Products at the top-20 percent line are appreciating at about two percent since early summer 2003, albeit with some fluctuation. Just looking at the price appreciation of products that presently compose the top 10 or 20 percent within the domestic corporate goods price index, it is clear that the largest impact on the appre-

ciation does not originate in China. Instead, the price appreciation should be ascribed to domestic forces or to forces at work in the global economy as a whole.

began to show improvement from around spring of last year, being adjusted a little bit at a time within Japan, perhaps reflecting trends in the overall international economy.

flexibility in its capacity to supply labor-intensive products, but this fact in itself isn't enough to transform the base of Japan's economic structure overnight.

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At the same time, about half of all the product prices actually fell in the 12-month period. Further, 20 percent of them showed neither appreciation nor depreciation during the past several months. Simply put, the prices of 20 percent of the indexed products are hovering around zero, 30 percent of the products have increased in the past year, and 50 percent have fallen. The overall average for these 1,300 products, then, is a 0.2 percent increase in March over the same month in the previous year.

It is plain to see that some prices have been driven up by surging Chinese demand. But those products only account for less than 10 percent of the total – clearly not enough to have ended Japanese deflation. This phenomenon is just a small part of the overall story, and those products that form the larger outline of the Japanese economy

The media seems to have misunderstood the causal link between Chinese demand and easing Japanese deflationary pressure. Common sense tells us that there's no way that Japan's emergence from deflation can be owed to surging Chinese demand – Japan's GDP (¥500 trillion), is more than three times larger than China's, even if the comparison is made on the basis of purchasing power parity. Thus, if China's economy is only a third, or perhaps even a fourth as large as Japan's, an overheating of one part of China's much-smaller economy is not of sufficient scale to benefit Japan's economy as a whole. The difference in the size of the two economies is simply too large for China to have that much of an effect on Japan.

There is, of course, a China effect on the Japanese economy. China possesses essentially limitless

Instead, the supply side of the Japanese economy should be examined as the root cause of the recent up-tick in the domestic economy. Corporate Japan has increasingly become aware of China's challenge, and is moving to differentiate its supply structure. We have to tackle China's challenge through more realistic approach while utilizing statistical materials available to everybody. Economic analysts, including me, should keep this in mind. ■

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and international prestige through its economic contributions, the US made it clear that it still measured security in the traditional currency of military force.^{vi}

The breakup of the Soviet Union and its European empire revitalized Japan's impulse toward multilateralism and multilateral diplomacy.^{vii} Japanese policymakers began to search for increased regional security arrangements, particularly in Asia but also in enhanced ties to Europe, that would allow it to claim a more active contribution to 'burden sharing,' while reducing its dependence on the bilateral relationship alone.

Overall, both the US and Japan began to rely increasingly on multi-

lateral organizations as an additional set of tools with which to 'manage' their financial and economic relations and both have sought on various occasions to pursue their trade issues, not through direct negotiations as had once been the case, but rather through the WTO dispute settlement system.

In these and other ways, therefore, multilateral organizations, both those focused primarily on Asia, and those that are truly global, now provide a totally new array of forums within which both Japan and the US are reshaping their previously bilateral relations. To date, there is little clarity on which side gains more through such bodies. But preliminary results suggest that Japan has used them to considerable advantage to counterbalance its pre-

vious weaknesses under bilateralism. One undeniable consequence, however, is that both governments can now engage in "forum shopping," assessing in advance the potentially most valuable institution within which to raise any particular issue. No longer is either side limited to direct bilateral negotiations. ■

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