FIVE

Neomercantilism and Bilateral Trade Issues

The Bretton Woods system achieved its goals of material prosperity and international peace, but these successes were neither complete nor permanent. International institutions can constrain—but ultimately cannot prevent—the adoption of national policies that disrupt market-based trade[. If nations resolve trade dilemmas in different ways, trade between them is likely]to create foreign policy friction. Nowhere is this more evident than in the conflict-ridden trade relations between the United States and Japan, the focus of this chapter.

U.S.-Japanese trade tensions

The signs of trade-induced strain between the United States and Japan are evident in both formal diplomatic relations and in public opinion, with so-called Japan-bashing often heard on street corners and in Congress. [More Americans (45%) see economic competition from Japan as a critical threat to U.S. interests than the military power of Russia (34%), Islamic fundamentalism(38%) or regional ethnic conflict (34%)[1] Polls show that only 43% of Americans have a favorable opinion of Japan and 53% believe that U.S. - Japanese cooperation is only fair or poor. It is revealing that only 25% believe that the American and Japanese people have a good understanding of one another.

U.S. complaints center on the bilateral trade deficit with Japan, which has hovered around $50 billion annually since 1985 and which [approached] $65 billion in 1998. [55% of Americans attribute the imbalance to Japan's refusal to open its markets; only 17% cite the competitive weakness of American firms, while among opinion leaders those figures are 63% and 7% respectively.[2]] Japan rejects culpability for the deficit: A [recent] poll revealed that 85 percent of Japanese felt that America unfairly blames Japan. Furthermore, Japan complains that American efforts to reduce the trade deficit violate principles that are both imbedded in international law and regularly professed by American trade officials. As a result, a recent poll found that only 45 percent of the Japanese [...] regard America as trustworthy.

It is difficult to overstate the significance of this trade conflict between the globe's two largest national economies, which together account for about one-third of total world production. It jeopardizes their bilateral trade, which at more than $180 billion per year in the late 1990s exceeded that of any other pair of nations except the United States and Canada. Japan depends on U.S. markets to accept about 30 percent of its exports and on American products, which constitute nearly 25 percent of its imports.[3] The fallout from the trade dispute could also endanger other facets of the economic relationship. For example, the United States relies on Japanese capital to supply needed investment funds—Japanese investors hold more than $130 billion in foreign direct investment in the United States and a [sizable share of the $725 billion in] U.S. Treasury bonds[held abroad]—and Japanese investors depend upon the health of the American economy to generate returns on that investment. Furthermore, the credibility—perhaps even the survival—of the WTO, the centerpiece of the world trade order, may hang in the balance. In May 1995, the United States, which had been the chief sponsor of the WTO when created only six months previously, threatened sanctions against Japan that, if imposed, would have violated WTO rules.

At the heart of the dispute are complaints by American business that Japan exports too much and imports too little. Accusations of unfair trading practices have been accompanied by calls for the management of trade by the United States in order to ensure a level playing field. In fact, the phrase "fair trade" is now more often articulated as a goal than "free trade." U.S. labor has reacted stridently to the influx of Japanese products in the United States, arguing that imports steal American jobs. The bitterness is reflected in heated rhetoric, such as U.S. Representative John Dingell of Michigan's declaration that "there's only one reason our automobile industry is hurting—those little yellow people."[4] The view from the other side of the Pacific is different: Yoshio Sakurauchi, the speaker of Japan's lower house, opined that America can't compete because "U.S. workers are too lazy" and that "about 30 percent" of American workers "cannot even read." It is difficult to avoid the conclusion that racism plays a role in the perceptions by each nation of the other, but real economic differences lie beneath the bombast.

Friendly partners?

The case for attributing the bilateral trade imbalance to unfair Japanese practices receives support from the observation that Japan has maintained a trade surplus with the rest of the world—not just with the United States. In fact, other nations have also denounced Japan's trade surplus, which exceeded $100 billion per year from 1992 to 1995 and averaged about 2.5 percent of its **gross domestic product** (GDP) throughout the 1990s. Indeed, Japan has had difficult economic relations for some time: Fourteen nations invoked Article 35 of the GATT in refusing to accord MFN status to Japan when it became a contracting party in 1955. In the 1980s, Japan was warned by the German economics minister that "trade should not be a one-way street" and by the British prime minister that the trade imbalance "cannot continue without threatening the breakdown of the free trading system."[5]

This antagonism is magnified because Japan runs large trade deficits with countries that supply raw materials and large surpluses with most developed nations.[6] In the latter countries, such as the United States, sectors that compete with Japanese imports constitute a strong domestic political constituency that is hostile toward Japanese trade. Ordinarily, protectionist pressures emanating from import-competing sectors are counterbalanced by liberal lobbying from the export sector, but the bilateral trade deficits that most advanced countries run with Japan translate into a deficit [in liberal sentiment]. As a result, Japan has been forced to reach agreements with European governments similar to those negotiated with the United States, such as export restraints on automobiles.

Nevertheless, with a **current account** surplus during the 1990s of over $700 billion, Japan has become the largest creditor in global history. Japanese ownership of foreign assets exceeded $2 trillion early in the 1990s and continues to grow each year, a pattern bound to alarm those who see trade as a zero-sum game in which one nation can gain power at the expense of others. The holdings of Japanese investors abroad, about 12 percent of the global total of foreign direct investment, dwarfs the ownership of foreigners in Japan, which amounts to about .7% of the total. In short, the U.S.-Japanese trade gap reflects forces at work in Japan's relations with other nations as well.

At the same time, however, Japan uses a similar logic in locating the source of the bilateral imbalance in U.S. economic policy, noting that the American trade deficit is not unique to its links with Japan. Indeed, the United States has become the world's largest debtor after a decade of current-account deficits exceeding $1 trillion. Because the gap with Japan accounts for only about 40 percent of that, many feel that Japan is being used as a scapegoat for a broader American problem. They argue that the bilateral trade imbalance with Japan—and the related decrease in the value of the dollar from over 300 yen in the 1960s to under 100 yen in the 1990s—may be a symbol of American decline but not its cause. As one commentator put it, "To blame Japan for U.S. trade deficits is a lot like blaming your banker because you are in debt."[7]

Indeed, American fixation on the trade deficit with Japan is partly a reflection of anxiety about the loss of American hegemony. Although still the world's largest economy and exporter, the United States is no longer as far ahead of its competitors as it once was. In the early 1950s the United States accounted for about 45 percent of total global production (including 80 percent of the world's cars), held 43 percent of international reserves, and furnished about 20 percent of global exports. By the beginning of the 1990s, U.S. production and exports had grown significantly, but because that growth was not nearly as rapid as that in the rest of the world, U.S. production had slipped to about 25 percent of total output, international reserves were down to 6 percent of the global total, and U.S. exports made up less than 12 percent of international trade. American firms no longer produced 80 percent of the autos driven in the United States, let alone in the entire world.[8] Meanwhile, Japan's exports had grown from 2 percent to 10 percent of the global total.

Americans, having gotten used to global dominance, naturally assumed that something had gone frightfully wrong when it began to diminish. Realistically, however, it is the 1950s that should be considered exceptional—U.S. dominance in the immediate postwar period represented the greatest concentration of economic power by any one nation in history. The global depression of the 1920s and 1930s, a massively devastating war fought on the territory of the other leading economic powers in the 1940s, and the unusually prominent role of the United States in Europe in the immediate aftermath of that war all helped to propel the United States to a position of dominance that could not possibly be sustained after the recovery that eventually ensued.

Still, it cannot be surprising that such a steep relative decline would be psychologically disturbing to Americans. Furthermore, hegemonic stability theory reminds us that bilateral conflicts, along with the rising tide of regionalism and mercantilism that helps spawn them, are characteristic of any period of declining hegemony. Thus, because the 1990s mark the culmination of two decades of relative decline by the United States and five decades of remarkable growth in Japan, the contemporary strain in bilateral relations between these two powers should not be too surprising. Also, these conditions merely bring to the fore a conflict that is always latent among trading nations because it stems from a fundamental dilemma built into the way that international trade affects the state.[9]

THE EFFECTS OF INTERNATIONAL TRADE ON THE STATE

Despite liberal insistence that trade produces peace, the historical record shows that trade-related conflict is far from unique to the American-Japanese case. Theorists such as Harold Laski and E. H. Carr argue that the expansion of trade frequently creates competitive struggles for markets, raw materials, and investment outlets. The hostilities that led to World War I have been attributed to national rivalries sharpened by a drive for colonies motivated by this competition. Both Japanese and German justifications for World War II cited similar goals in the drive for spheres of influence that ultimately became campaigns of conquest.

Common to these cases is a structural reality emphasized by mercantilists: States cooperate for economic gain; they also use trade to compete for political power. It is ironic that this dualistic facet of international relations is portrayed most vividly by the liberal theorist Adam Smith:

> Being neighbors, [England and France] are necessarily enemies, and the wealth and power of each becomes, upon that account more formidable t
> what would increase the advantage of national friendship serves only to inflame the violence of national animosity.[10]

Thus, the attitude of a nation toward the economic success of a trade partner is torn between these two visions.

> The wealth of a neighboring nation, however, though dangerous in war and politics, is certainly advantageous in trade. In a state of hostility it ma
> enemies to maintain fleets and armies superior to our own; but in a state of peace and commerce it must likewise enable them to exchange with u
> and to afford a better market...for the produce of our own industry.[11]

A market perspective sees neighboring nations as potential customers, but the state must also see them as potential enemies. Which resolution of this dilemma will dominate policy depends upon circumstances. If conflict seems likely—or even possible—the state must consider not only the absolute gains from trade but also its relative gains. Following Smith's famous observation that "defence is more important than opulence," it may then be necessary for a state to refrain from trade that would be more advantageous to its potential enemies than to itself. As a result, conflict becomes most likely when changes in respective power levels become visible, because that is when a nation becomes less concerned with its own absolute gain than with the relative gain of a rival.

Whereas few analysts expect the American-Japanese economic rivalry to erupt into war, many do suggest that the United States should seek to strike a balance between these two considerations. That is, in recognition of the dilemma, the United States should manage trade so as to minimize the long-term threat to national interests that the rapid ascendance of a rival may represent. In practice, that means insisting upon reciprocity in trade relations so that neither party gains more than the other even if it requires limiting trade and sacrificing some of its benefits. It also means emphasizing trade with partners who are more likely to be allies than enemies, because trade may cement a friendly relationship while intensifying the conflict in an antagonistic one. Such a policy is a dangerous tightrope, however, because, as liberals note, interference with trade, especially in a discriminatory way, has often triggered major conflicts. Nonetheless, critics of American trade policy point to the persistence of the trade deficit as evidence that the United States has been less attentive than Japan to the long-term implications of trade for these power-related dimensions of the national interest.

Trade may also generate dilemmas for the state by conveying macroeconomic conditions such as inflation, employment levels, and interest rates from one nation to its trading partners. For example, during the 1930s, the American depression spread worldwide, in part because the decline of American imports meant unemployment for the export sectors of other nations. The consequences of this interdependence will be relatively benign if trade partners have similar macroeconomic goals, but if they do not, trade may be disruptive enough to produce foreign policy tensions.

Unfortunately, the United States and Japan pursue quite different values, and the resulting divergence in economic policy brings injury to both. [As Stephen D. Cohen has put it:

> Domestically, the United States has embodied the cowboy spirit: an emphasis on consumption and recreation, the spirit of individual freedom an conquer, distrust of government, and the glory of the free market. Meanwhile, Japan has embodied the samurai spirit: an emphasis on production of hard work, loyalty and subordination of self-gratification to group interests, respect for government authority, and the need for limiting the fre invisible hand of the marketplace."[12]

In particular], the two countries display very different attitudes toward the value trade-off represented by the choice of consuming today versus saving for tomorrow. Japanese economic policy strongly encourages savings and discourages consumption, thereby reinforcing a preference that appears to be prevalent among Japanese households anyway. Restraining consumption carries the side effect of limiting Japanese imports, which constrains the exports and slows the growth of other economies, especially the United States. In response, other nations have pressured Japan to stimulate its economy through increased government spending in the hope that the resulting rise in Japanese imports would also stimulate their economies. [This pressure has been especially intense in recent years because the prolonged Japanese recession of the 1990s has been a drag on the recovery of the export-led economies of Asia from their 1997 collapse.] By contrast, the United States maintains an unusually low national savings rate. As a result, high levels of individual, corporate, and government debt require foreign borrowing that limits the supply of investment funds available elsewhere in the world. Consequently, other nations—especially Japan—have urged the U.S. government to cut its budget deficit [in order to] lower imports (by limiting American consumption) and stem the disruptive flow of capital out of their economies. [Despite considerable effort, neither state has been very successful in overcoming the proclivities of its respective economy. The U.S. budget deficit has disappeared but private consumption continues to accelerate and record import levels have produced record trade deficits. The Japanese government has boosted spending to stimulate the economy, but in the process has incurred massive budget deficits without generating the increases in private consumption or import levels that would reduce its trade surplus.]

The tensions created by such disruptive interdependence can be minimized if the injured party accepts a charitable interpretation of the motivations of the other, but this is likely only when nations are already inclined toward friendship. For example, during the Cold War, the presence of the Soviet Union as a common enemy unified American and Japanese foreign policy interests and soothed economic tensions. Now, however, differences in culture and ethnicity reinforce lingering wariness from World War II, all of which inflame and complicate a conflict that remains rooted in a $50 billion per year bilateral trade imbalance.

Of course, Senator John Danforth has said that "the issue is not the size of the trade deficit; the issue is to make sure that both sides play by the same rules."[13] But that is precisely the problem: It is difficult to agree upon rules when judgments of what is fair are so deeply imbedded in such very different cultural and theoretical systems. Because the issues touch upon dilemmas of trade that are evaluated very differently on opposite sides of the Pacific, each party finds it easier to see the other as a competitor and an enemy than as a partner and an ally.

Differences in trade policies

Simply put, major differences in the economic policies of the United States and Japan make a collision between them inevitable. In particular, American and Japanese trade policies have moved in opposite directions since the end of World War II, just as predicted by List when he observed that dominant nations are typically free traders and trailing nations usually adopt a protectionist stance. Japan, which had lagged behind Europe and North America in productivity even before the war devastation, adopted a mercantilist trade policy that emphasized promotion of exports and protection from imports. Since about 1975, however, when Japan became fully competitive in global markets, its trade policy has moved away from mercantilist extremes.[14] Indeed, by the mid–1980s Japanese tariffs were comparable to those of the United States and the EU, though the actual level of imports remains lower in Japan than in other developed nations.

Meanwhile, as American economic and political dominance declined after the early 1970s, U.S. policy slowly drifted away from the liberalism it had embraced as a hegemonic leader. Though the United States remains committed to a liberal international system, American policy has become more aggressive in tone, more unilateral in spirit, and more mercantilist in substance. Its trade policy now emphasizes a range of defensive tools that, though meant to support its liberal rhetoric, are increasingly seen as protectionist by others and as the *source* of trade tensions rather than an antidote to them. In short, most commentators still see American trade policy as predominantly liberal and Japanese trade policy as predominantly mercantilist, but the differences between them have dramatically narrowed in recent years.

Still, the differences between the trade policies of the United States and Japan are much greater than can be explained by the competitiveness of their firms in international markets. In fact, they lie in prevailing theories and values, the state of markets, and the balance of power among key domestic and international actors. Each of these factors helps to explain why the two nations have judged the dilemmas of trade so differently and adopted divergent policies that reflect their respective judgments.

JAPANESE TRADE POLICY

Though Japanese trade policy includes some components of classical mercantilism that were shared by American commercial policy for most of the republic's history, fundamental structural disparities in the American and Japanese political economies reflect the great variations in historical forces that have shaped modern life in the two countries. The most striking differences stem from the divergent paths they followed in the immediate postwar period. One compelling characterization of their respective goals is that Japan sought to create a production machine, whereas as America emphasized a consumer society. In particular, Japanese economic policy since World War II has been shaped by an unusual commitment to rapid growth fueled by an export sector geared to the global market. It has also been fostered by an unusually dominant role for the state in mobilizing the energies of the private sector to fulfill that philosophy.

In one sense, this strategy needs no special explanation because less competitive nations are almost always mercantilist. But the ferocity of Japan's commitment to a trade policy that emphasizes national power over individual welfare and future growth over current consumption is explained by that country's unique position and history. The experience of World War II and the postwar American occupation illustrated graphically how much Japan lagged behind the rest of the developed world and how significantly that gap could affect Japanese life. The result was a national commitment to recover from the humiliation of this period and [to]restore national pride. At the same time, because Japan was very poorly endowed in key natural resources, it had to maintain a significant level of imports. The need to sell exports to pay for them thus ruled out any form of autarchic development. Finally, unlike European nations, it was located in a region consisting of very poor economies that offered few marketing opportunities, so it had to orient its trade relationships to global rather than regional markets. Thus, it was imperative that Japanese firms be able to compete successfully in export markets against companies from far more developed nations that had a considerable head start.

Consequently, trade became the focal point of a far-reaching industrial policy through which the state shaped Japan's postwar economy. Policy makers sought to develop globally competitive firms in a few well-chosen sectors that promised long-term growth. The methods combined initial import protection—motivated by infant-industry arguments that date to at least Elizabethan England—with vigorous export-promotion programs centered around credit provided at very favorable terms by the state-run Japan Development Bank. Achieving rapid export growth required a complex set of policies that controlled credit and imports, permitted monopoly situations unthinkable in the American context, and deprived certain sectors (and consumers in general) to advance others. Direct subsidies, tax relief, and public support of research and development consortia, in addition to easy credit, fueled a huge expansion of investment.[15]

These efforts were coordinated by Japan's Ministry of Finance (MOF) and **Ministry of International Trade and Industry** (MITI). The unusually close connection between the government and private industry and the unusually prominent position of MOF and MITI within the government gave rise to the term **Japan, Inc.** to describe the total social mobilization undertaken in support of these fledgling export industries. This could occur only because of the unique communitarian values, the rare national consensus, and the unusual structure of Japanese government. Bureaucrats attained high social prestige during the Tokugawa (feudal) period (1603–1867) and retained it as they led the modernization process under Emperor Meiji (1867–1912). In the mid-1990s, MITI and MOF officials, who are mostly graduates of Tokyo University, Japan's most prestigious, remain a business elite. Usually career bureaucrats, they achieve considerable power to influence the behavior of private firms through "administrative guidance." When they eventually retire from government service to the private sector, they are said to "descend from heaven." The less lofty prestige of government officials in the United States is reflected in the comparable American colloquialism that they enter a "revolving door."[16] As a result, government efforts to steer the Japanese economy encounter little of the resistance from the private sector that is such a distinguishing feature of the American political system, especially during the current era dominated by antigovernment sentiments.

The propensity of government policy to intervene in markets is so central to its system that Japanese scholars have suggested that the Japanese political economy represents a structurally distinctive system. In fact, Japan has been called a "non-capitalist market economy" by one and an example of "network capitalism" (distinguished from American market capitalism) by another.[17] Indeed, interference with the market mechanism is a core feature of the Japanese political economy and is by no means restricted to government intervention.

The so-called ***keiretsu***, a network of firms linked through product markets, labor markets, and financial markets, exemplifies the prominent role played by nonmarket forces in the Japanese economy. These business empires had their origins in the family-controlled holding companies called ***zaibatsu***, which prospered prior to the imposition of antitrust policy by American occupying forces immediately after World War II. The four largest of them accounted for about one-quarter of all capital in Japan in 1946 and controlled half of the financial markets and a third of heavy industry.[18] When holding companies were outlawed, many zaibatsu re-formed under a similar structure of cross-shareholding called keiretsu, centered around banks.

For example, the Mitsui keiretsu consists of twenty four major companies linked together by stock in each firm that is owned by the others. In fact, more than 50 percent of the shares of these firms is held within the group. The companies also buy and sell from one another as well as share market information, provide credit, and cooperate in various other ways. Mitsui includes two banks, two insurance companies, a real estate firm, a shipper, a warehouse, an engineering company, a retailer, and producers of textiles, chemicals, mining products, and petroleum, as well as world famous firms that produce electronics (Toshiba) and automobiles (Toyota). In the early 1990s, the six largest keiretsu accounted for about 16 percent of capital and profits in the Japanese economy and held about 25 percent of the outstanding shares on the Tokyo and Osaka stock exchanges.[19]

Naturally, these industrial structures shape the behavior of firms. Japanese companies are likely to respond to a variety of stakeholders—especially affiliated firms—whereas U.S. corporations are more single-minded in producing profit for shareholders. As a result, the planning perspective of Japanese companies is long-term and broad in scope; indeed, they may not even be profit maximizers in the same way that American firms are. For example, a company may pass up the lowest-cost supplier in order to buy from another member of its keiretsu, since as a shareholder in the latter it would earn part of the profit. Further, these large keiretsu often cooperate with one another to form an oligopoly, which, like monopoly control over a market, raises prices for consumers and increases profits for business.

Moreover, oligopolies are much more common in Japan than in the United States because antitrust policies, though by statute similar to American ones, have been weakened by amendment and are underenforced. For example, antitrust exemptions allow legalized cartels in declining industries (to cooperate in reducing excess capacity), among small- and medium-sized enterprises (to achieve economies of scale), and for “rationalization” (to improve an industry’s overall performance), as well as to facilitate exports and limit imports. All these cartels operate under the principle that “excessive competition” can be injurious to a firm and an industry, thus undermining its competitiveness against foreign firms. By the 1960s more than 1,000 cartels had been explicitly exempted from the antimonopoly law by the Fair Trade Commission. Even when the Fair Trade Commission has attempted to discourage collusion and centralization, it has often been pitted against the more politically powerful Ministry of Trade and Industry, which helped to create and sustain many of these very same cartels. Further, no plaintiff has ever won a private antitrust suit in Japan.

State-based export-promotion policies have also been integrated with private efforts. Large general trading companies (*sogo shosha*) have formed to facilitate the entry of smaller firms into foreign markets by providing marketing expertise, transport facilities, and credit. The nine largest, each associated with a particular keiretsu, handle 47 percent of Japanese exports, 65 percent of imports, and 18 percent of domestic wholesale sales.[20] Aided by the government-run Japanese External Trade Organization, which maintains offices in more than fifty foreign countries, Japanese firms find it relatively easy to monitor foreign markets so as to compete more effectively. By contrast, U.S. firms lack such extensive help in marketing in Japan and often bear the further burden of ignorance of Japanese language, customs, and business practices. Every anecdote about Japanese government interference with trade—from minor annoyance to outright ban—can be matched with another tale of the difficulty of doing business in Japan without appreciating that the rules of business interaction in Japan are as different as the rules of social interaction.

It is not hard to see why these arrangements have aroused the ire of other nations, especially the United States. They diminish the role of purely market-based competition that is open to all in favor of cooperative networks of elites that tend to be closed to outsiders, especially foreigners. Not only do they encourage exports and discourage imports, they do so through nongovernmental processes that cannot be easily identified or targeted as outright violations of WTO rules.

For example, Japan’s notoriously inefficient retailing system suppresses imports. Most retailers are small shopkeepers who must rely upon an extensive network of wholesalers to supply the goods they sell. However, these wholesalers are usually affiliated with manufacturers, who can legally prohibit retailers from selling the products of competitors. Furthermore, because retailing licenses are required and existing merchants can block the granting of new ones, it is difficult to establish large chain stores that would be less reliant upon existing wholesalers and more price competitive. All of these arrangements make it difficult for new producers or foreign firms to get their products onto store shelves, the central allegation made by Kodak against Fuji in a 1995 dispute over color film that brought the two nations near a trade war. Of course, by severely restricting competition this system also drives up consumer prices. The WTO ruled that Japanese practices did not constitute a GATT violation and Japan has since passed a new Large Scale Retail Store Location Law, but the U.S. continues to issue a semi-annual report “assessing Japan's implementation of the representations it made to the WTO regarding the openness of its photographic film and paper market.” [21]

At the same time that these structural features of the Japanese political economy discourage imports, others tend to increase exports. For example, in keeping with the Japanese tradition of lifelong employment, companies do not usually lay off workers even when sales decline. This constraint shapes labor-management relations, transforms the trade-offs involved in pricing and production decisions by firms, and changes the nature of political pressures on government macroeconomic policy. It is especially prominent in motivating corporate behavior that is otherwise inexplicable; for example, American competitors contend that Japanese firms engage in "dumping," selling products in the American market at a price that does not earn a profit. Since workers will be paid anyway, Japanese firms have an incentive to continue production under market conditions that would make an American firm discontinue operations.[22]

Thus, under the influence of both overt mercantilist policies and more subtle influences built into the fabric of economic structure, the Japanese economy in general—and several specific export industries in particular—achieved great technical sophistication and market success. Specifically, Japanese firms achieved global dominance in textiles in the 1950s, electronics in the 1960s, and autos in the 1970s and 1980s.

As the conditions that sustain this policy have changed, Japanese policy has moved in a markedly more liberal direction since the late 1970s. Industrial policy is now much less aggressive, allowing market forces to assume a considerably greater role. Further, import protection has assumed the pattern more common in other developed market democracies, emphasizing the support of declining industries rather than the expansion of those with growth potential. Though tariffs and most nontariff barriers have visibly declined, critics contend that protectionism has not diminished so much as the predominant methods of import control have shifted. They now include arrangements that are difficult to document, such as administrative guidance on the part of government officials designed to intimidate importers, incomplete enforcement of intellectual property rights, government procurement policies biased against imports, and technical barriers to trade such as misuse of customs procedures and product standards.[23] [It is no coincidence that theUruguay Round agenda included measures in each of these areas.] On the evidence of actual import levels, which are much lower in most industrial sectors than in other countries, various structural impediments remain, especially involving restrictions on distribution channels for imports. For example, only 3 percent of autos in Japan are imported, but in most developed nations the proportion is between one-third and one-half.

American attempts to assess Japanese economic policy typically stumble over two major puzzles. How can such antiliberal policies succeed? Why have they been tolerated? Both questions arise because liberal theory contends that all of these structures that supplant the private market—keiretsu, cartels, vertically integrated retailing, import barriers, export subsidies, and other government intervention—sacrifice consumer welfare. It is certainly surprising that policies that harm consumers could persist so long within a democracy. The key to understanding the differences between Japanese and American trade policy lies in the recognition that they pursue different goals, each representing a distinctive response to the trade dilemmas that all nations must resolve.

Although a full explanation of these choices would carry us too far afield, it is essential to realize that foreign trade permits these apparent sacrifices of consumer welfare to be interpreted in ways that strengthen their appeal. Most important, trade provides a means to exchange some loss of current consumption for

Japanese and American Responses to Trade Dilemmas

Japan	*United States*
1. Value trade-offs	
Trade should be regulated to achieve social justice, domestic stability, and future national power and prosperity.	Trade should be free to maximize individual consumption, global efficiency, and stable world order.
2. Distributional outcomes	
Trade should be regulated to protect workers, benefit desirable sectors, and shift welfare into the future.	Trade should be free to maximize current consumer welfare and encourage efficient sectors.
3. Effects on the state	
Trade should be regulated to enhance national power and autonomy.	Trade should be free to achieve inter-Dependence and peace.

alternative values such as full employment (to minimize instability and inequality), Japanese national power, and future consumer welfare. For example, the foreign currencies earned by the trade surplus have been used to greatly expand Japan's foreign direct investment abroad. Japanese FDI, which now amounts to about 12% of the global total (up from 0.7% in 1960), continues to earn profits that can be enjoyed long after the trade surplus that gave rise to it. Moreover, Japanese economic policy—in both its domestic and international dimensions—rests on economic theory that directly challenges key assumptions of liberalism.

STRATEGIC TRADE THEORY AND POLICY

Like early English mercantilism, postwar Japanese trade policy was not erected on an edifice of formal economic theory. Whereas liberalism contains an integrated body of precise premises, refined logical arguments, and universalistic policy conclusions, **neomercantilism** has always consisted of fragmented practical wisdom derived from an eclectic mix of past policy successes, tactical judgments, and a smattering of theoretical ideas. However, economic theorists have always followed in the wake of successful practice, so in recent years a body of thought now called **strategic trade theory** has arisen to explain the most novel aspects of the Japanese neomercantilist approach.

Of course, many elements of Japanese policy reflect age-old motivations and well-known policy initiatives. The distinctiveness of the Japanese experience lies in its artful integration of domestic industrial policy with promotion of the export sector and protection against imports. Indeed, the administration of these policies has been so artful that many commentators—especially liberal theorists—doubt that such an approach can be made to work outside the special circumstances of postwar Japan. Few governments inherit the structural conditions and public consensus necessary to implement an approach that depends so centrally on trust in governmental institutions and sacrifice of current welfare for the promise of future payoffs.[...]

Nonetheless, recent theoretical advances—stimulated in part by the Japanese model—make a compelling case for export promotion and industrial policies. Strategic trade theory, which breaks with liberal theory in several important ways, is a refinement of older economy-of-scale ideas. Most important, it provides a defense for two propositions that are antithetical to liberal and free trade canon, though they have been accepted by countless governments for centuries. First, comparative advantage is not discovered by the savvy investor but actually created by a powerful state. Second, export promotion may be as essential to some infant industries as import protection because in some sectors a firm cannot be sustained by the market of a single country. For both reasons, government intervention is sometimes necessary to trade successfully. To see how this alternative explanation for trade suggests a greater role for the state, we must review the liberal premises that strategic trade theory challenges.

The liberal counsel that the state should avoid intervention in trade flows naturally from the Heckscher-Ohlin assumption that the sole basis for comparative advantage lies in national endowments of land, labor, and capital—which governments can do very little to affect. However, these endowments may play a smaller role in determining relative production costs of modern high-technology products than they did with respect to the simpler products considered by Smith and Ricardo. Further, factors of production are no longer immobile across national boundaries. For example, American capital is readily available to Mexican firms if they have the other attributes needed to be competitive, such as technology, consumer brand-name loyalty, marketing expertise, product innovations, and, most important for our purposes, favorable government policy (especially subsidies). Of course, government subsidies have always been capable of affording competitive advantage to firms over those of other countries, but such a policy was regarded as self-defeating for the economy as a whole because subsidies require tax revenue to fund them.

However, government intervention would be appropriate if comparative advantage rested on some factor that could be provided at no net cost only by the state. Strategic trade theory suggests at least three such candidates: very large scale capital, coordination among competing firms, and a credible commitment to aggressive export-promotion policies. To be successful, though, all require the existence of economies of scale; that is, the unit cost of production must decline as the volume of production increases. Of course, to some extent all products benefit from economies of scale. After all, it is hard to name a product that cannot be mass produced more cheaply than made one at a time. But most products reach a point where higher production volumes carry no further cost advantage because a very large organization becomes increasingly inefficient.

Economies of scale sometimes persist even at a volume that saturates the market, however, especially when the variable costs of production are low in relation to the fixed costs. For example, the major cost for Microsoft in producing its computer software—paying programmers for the creative process of writing it—is fixed regardless of how many copies are sold. Its variable costs—buying blank disks to distribute the software—are very small. Consequently, once Microsoft has sold enough copies to recoup its fixed costs, it can sell additional copies profitably at a price that cannot possibly be met by a new firm that produces a competing product in much smaller volumes.[24] Because comparative advantage in such industries resides wherever large-scale production is initiated, an industrial policy that subsidizes start-up may be beneficial to firms breaking ground in new technologies. Of course, subsidies will be absolutely essential to start-up firms in such sectors if foreign firms are already established. Subsidies need not cause a loss of consumer welfare but only a postponement of it, because the mature firm should eventually generate employment, profits, and tax revenue that repay the state for its initial support. If so, a mercantilist industrial policy may itself be a source of comparative advantage and a major national asset.

Critics of industrial policy correctly observe that the state is not the only source of venture capital to initiate such industries and that private entrepreneurs may be better at picking winners and losers than government bureaucrats. Nonetheless, when very large scale capital is required for a risky venture, the state may be the only realistic source. That is especially true when economies of scale accrue outside the firm itself but inside the nation in which it is located. For example, the concentration of chipmakers and computer industries in the Silicon Valley of California makes it profitable for similar firms to locate in the same area, taking advantage of the skilled technicians and the research expertise of those already employed there. Because the original companies produce advantages enjoyed by new companies—pioneers such as IBM and Apple paved the way for countless others—it may not pay private investors to initiate a dynamic industry even though it would benefit the economy of the nation. In cases of market failure like this—that is, when the private market fails to provide adequate capital because of externalities—the state can play a pivotal role.

Furthermore, a state with an activist industrial policy can bestow sources of comparative advantage that no private market can provide, such as subsidies for pure research or relief from onerous laws and regulations (e.g., antitrust). But the most formidable weapon of strategic trade policy is the reputation of the state itself for aggressively supporting an industry and ruthlessly competing with rivals. The promise to subsidize firms (or benefit them in other ways) well beyond the capacity of an unsubsidized firm to respond can intimidate potential competitors in other countries. Indeed, if the intimidation is great enough, neither the initial advantage nor the economies of scale need be especially large. Certainly the reputation of Japan, Inc. discouraged some American firms from competing in consumer electronics because they were convinced that the Japanese government commitment to capturing the American market would make their efforts futile and costly.

Thus, where economies-of-scale considerations loom large, government interference with the private market yields benefits not recognized by free trade theory. But why has Japan been so much more aggressive than the United States in exploiting these possibilities? Why has Japanese trade policy been predominantly mercantilist and American policy more liberal?

The different roots of American and Japanese trade policy

It is useful to recall the lesson contained in our analysis of early England: An intimate connection always exists between a nation's trade policy and the remainder of its political economy. The same forces that shape a nation's response to trade dilemmas—various strands of social and economic theory, the state of markets, and prevailing power balances among key actors—also influence the evolution of the domestic economy.

The liberalism of American trade policy reflects a domestic economic policy that also avoids state intervention in the market. For example, Japan (and most European nations) adopted an industrial policy that confers government benefits to selected sectors in order to build globally competitive industries; in contrast, the United States has emphasized a competition policy that emphasizes antitrust actions to prevent monopolies or oligopolies.[25] In particular, the Federal Trade Commission prevents market dominance by blocking mergers or acquisitions that would lower the number of competitors beyond a critical threshold. This strategy exemplifies the liberal conviction that efficiency is best promoted by competition among multiple firms and that government need only prevent business collusion that would lead to stagnation in productivity enhancement, product innovation, and consumer welfare. By contrast, the Japanese approach deemphasizes antitrust, instead relying on foreign competition to fill whatever gaps are left by the absence of domestic competitors. Japanese leaders recognize that concentration of market power, control over prices, and sharing of effort is necessary to compete against foreign firms, especially those not restricted by antitrust laws in their own countries.

The difference can be explained simply: Japanese policy evolved in response to foreign competition, and American policy has its roots in an era in which foreign competition was insignificant in the United States. During its formative period, the United States enjoyed relative autonomy from international forces. Because of the sheer size of the American market and a plentiful endowment of natural resources, the country could produce most of what it needed and could sell within its own borders most that it could produce. This made it feasible for the United States to limit trade to a degree utterly impossible for Japan, whose dearth of resources and smaller market prevented self-sufficiency. At first because of the protection offered by tariffs and by high transportation costs resulting from physical isolation from trade competitors, the U.S. economy evolved an internal orientation almost without precedent. Even the post–World War II liberalization did not threaten most American firms, which had become competitive abroad and so dominant at home that as late as 1960 imports made up less than 5 percent of U.S. GNP. In the face of these market conditions, it is hardly surprising that industrial policy did not arise but antitrust policy did: Industrial policy is motivated by the presence of foreign competition, whereas antitrust policy is imperative in its absence.

Explanations for Postwar Trade Policy

Japan		*United States*
	1. State of theory	
Communitarian ethical theory; neo-mercantilist and state-directed theory of trade and industrial policy.		Materialist and individualist ethical theory; liberal macro-economic and trade theory.
	2. State of market	
Dependent on global markets, but inefficient.		Industry dominant over foreign competition.
	3. Political power balances	
Dominance by state personnel, keiretsu, and rural sector.		Private sector dominant.

Even though persistent U.S. balance-of-trade deficits demonstrate that foreign competition became much more formidable after the mid-1970s, an American industrial policy still has not emerged. The U.S. government lacks the ability to engage in successful industrial policy because it has no counterpart to Japan's MITI, whose expertise in coordinating import protection, credit subsidies, research and development consortia, cartel formation, marketing schemes, and export promotion are indispensable tools. Strategic trade policy also requires a level of trust between government and business that exists in Japan but not in the United States, where the relationship between the public sector and private business is more adversarial.

This strategy is especially well suited to the Japanese business environment because it rewards firms that pursue market share rather than immediate profit. By underpricing the competition, a firm can acquire a dominant position in a foreign market, which provides the leverage to raise prices in the future when the competition has been weakened or driven out of business altogether. Achieving market share is a goal consistent with the long-term view characteristic of Japanese firms but is not common in the United States.

Moreover, these strategies require that consumers sacrifice immediate welfare, which is more compatible with Japanese values than American ones. The Japanese willingness to defer consumption is symbolized by both a high savings rate and a trade surplus; the American budget deficit, trade deficit, and consumer debt levels are all testimony to the propensity of Americans to demand gratification sooner rather than later.

In fact, cultural differences between the two countries extend to a broad range of ethical theories and value judgments that are reflected in divergent economic structures and policies. The more communitarian tradition of Japanese culture finds expression in a variety of economic forms: reliance on personal networks rather than impersonal markets, lifelong employment practices, and consumption decisions that give preference to Japanese products, among others. This tradition also helped Japan achieve a national consensus after World War II in favor of a comprehensive industrial policy designed to use trade to achieve national goals and shift welfare from the present to the future. The U.S. political economy—and the trade policy that follows from it—has far different roots. It is built upon a structure formed by liberal theory and the individualistic and materialistic values that sustain it, much like the liberal period in nineteenth-century Britain. Thus, liberal theory has become an article of faith in America but not in Japan, which embraces the precept that too much competition can be as injurious as too little.

At the same time, the political power of key actors in both countries has played a major role in policy choice. For example, Japan's political structure allows the farm vote—the single strongest source of support for import protection—to elect something approaching 25 percent of the Diet, the Japanese parliament. Further, so many individuals benefit from each of the exclusionary arrangements—keiretsu, import restrictions, retailing networks, lifelong employment—that a substantial constituency exists for the system as a whole. Finally, the political culture does not encourage the challenges to community consensus or government policy that are more common in the United States. As a result, the Liberal Democratic Party, which created and sustained Japanese trade policy, enjoyed a near monopoly of political power for most of the postwar period.

In the United States, some critics have suggested an emulation of Japanese or European industrial policy, observing that a liberal approach leaves American workers vulnerable to foreign competition, which is particularly alarming because welfare provisions in the event of unemployment are much less generous in the United States than in Europe. However, because the United States lacks the leftist parties centered around a strong trade union movement, which marks the European social democracies, this argument has not been championed by an effective political power base. For a number of reasons, political power in the United States has been decentralized, and a sharp class-based cleavage has not appeared. As a result, the American state was smaller and less active in promoting welfare benefits than the typical European state, and less powerful and interventionist in shaping the economy than the typical Asian state.

Because Americans have such strong faith in the market—U.S. producers were among the most competitive in the world in all the leading sectors—and so little affection for government, it cannot be a surprise that American trade policy after World War II took on the same liberal orientation found in its domestic economic policy. Indeed, the United States sought to remake the global political economy in its own liberal image, confident that the burdens imposed on the country by the Bretton Woods commitments could be easily borne.

Contemporary American trade policy

By the middle of the 1970s, however, this optimism had faded; several key American industries, especially steel and autos, had lost their global dominance and a substantial share of their home market. Not surprisingly, these industries began to take a sharply protectionist view and an especially hawkish attitude toward trade policy with Japan. As theoretical conviction gave way to material interests, American policy slowly drifted in a more mercantilist direction, partly driven by the mercantilism of others.

American protectionism took several forms, some of which were fully in accord with GATT rules (and even consistent with liberal principles); others exploited gray areas in the agreement. GATT [...] allowed nations to increase tariffs in response to sudden changes in imports that diminished the income of any economic sector, even if they arose naturally from market forces and were desirable for long-term aggregate welfare.[26] In the United States, Section 201 of the Trade Reform Act of 1974 implemented GATT's Article 19 escape clause. It charged the U.S. International Trade Commission with investigating petitions for import relief and recommending action to the president. Between 1974 and 1986, fifty five cases were investigated under Section 201 and relief was provided in eighteen of them. During the 1990s, such actions were rare, with only one or two petitions per year.

Instead, the U.S. has preferred to rely upon the Trade Adjustment Assistance program (TAA) contained in Title II of the Trade Reform Act. Upon certification by the Secretary of Labor that unemployment has resulted from imports that reduce a firm's sales, the TAA grants benefits for retraining and relocation to workers displaced by foreign competition. In keeping with liberal theory, this approach facilitates adjustment to trade's effects rather than a cancellation of them, which would reduce the gains from trade and antagonize trading partners. Since 1975, more than 800,000 auto workers and over 400,00 textile workers were the largest groups certified for benefits, but five other industries had more than 100,000 beneficiaries each. During the 1990s, about 1500 petitions a year were initiated, with about two-thirds of them certified, covering about 100,000 workers per year. A special program provided similar assistance to 50,000 workers displaced by trade induced by NAFTA in 1998. About 200 firms a year have also received technical assistance in conjunction with import competition under the TAA.

More controversial has been the increasing American willingness to impose retaliatory tariffs against "unfair" trade competition. "Countervailing duties" are used to offset foreign subsidies so that American producers compete on a level playing field in the U.S. market. Remedial duties are used to protect American industry from injury caused by the dumping of foreign manufacturers, which consists of either selling a product abroad for below its cost of production or below the price for which it is sold in the home market. Antidumping charges were first filed by American television manufacturers against Japanese electronics firms in 1968, with the U.S. Customs Service finding that Japanese-made televisions were sold in the United States for as little as half their price in Japan.

Both measures are authorized under GATT 1947 and the clarifying agreements of the Uruguay Round, but other nations question whether the frequency of American use of them is consistent with the responsibilities of a liberal hegemon. Under the pressures of the massive trade deficit, bothCongress and the United States Trade Representative (USTR), the executive official charged with trade policy surveillance, have been hawkish on trade policy since the 1980s. The WTO reported that at the end of 1997, 87 countervailing duty measures were in force among its reporting members, 52 of those by the U.S. Of 880 anti-dumping actions in force, 302 of them were by the U.S.[27] The U.S. has also been the leading litigant in using the WTO dispute settlement mechanism 42 times since 1995. Critics charge that this behavior, a protectionist response to its own domestic economic interests, is inappropriate for a hegemon expected to be more concerned about the health of the global economy. Anti-dumping actions taken in 1999 against nations in severe crisis--Russia and the suffering Asian economies--added to this criticism.

Furthermore, the U.S. has used controversial provisions of section 301 of the Trade Act, which authorizes retaliation against any foreign manufacturer found to be engaging in “unjustifiable, unreasonable or discriminatory” trading practices, in ways that less powerful nations have been afraid to emulate. The USTR has initiated 118 investigations pursuant to Section301 since the statute was first enacted in1974. The Super 301 provision of the 1988 Trade Act goes further, with an emphasis upon identifying the products and markets that offer the best potential for the expansion of American exports. It places pressure on the president to designate “priority foreign countries” who maintain “unfair” trading practices and to set a deadline for progress in correcting them. The major target was clearly Japan, but both 301 and Super 301 have been broadly used in recent years. Moreover, all such actions produce “procedural protection” by serving as an example to other foreign producers who will avoid even the appearance of unfair competition so as to avoid the rigors of the U.S. legal process and possible retaliation. They also provide the teeth that encourage nations to seek bilateral negotiations with the United States over trade disputes.

In fact, before the Uruguay Round sharply restricted the practice, it had become common for nations—especially the United States—to require competitors to “voluntarily” reduce exports through bilateral voluntary restraint agreements (VRAs). Of course, when the United States asks another nation to restrict its exports and threatens retaliation if it does not agree, the agreement is voluntary in exactly the same sense that one hands over one’s wallet to a gun-toting mugger voluntarily.[28] The first voluntary export restriction, in cotton textiles, was adopted by Japan in 1955 and replaced in 1957 by a more formal bilateral agreement.The most notable of the VERs, however, arose from a conflict over automobiles that began in the 1970s and culminated in the early 1980s. In June 1980, the U.S. Senate adopted—by a vote of 90 to 4—a resolution calling on the Carter administration to send a signal to Japan by reviewing American import policies. However, significant American opposition to import controls came from consumer groups who valued the energy- efficient imports during a time of high gasoline prices and resented the lackadaisical approach of Detroit automakers to foreign competition from Japanese cars that were widely perceived to provide higher quality and lower prices. Heated public debate in the United States was mirrored by heated negotiations at the industry and governmental levels. The Reagan administration, committed to free trade but alarmed by the decline of the American auto industry, sought a voluntary export restraint by Japanese automakers that would achieve the desired end—a limit to foreign imports—while saving face for both sides. The United States did not wish to impose limitations that violated free market principles and the Japanese wanted to avoid action that would imply wrongdoing on their part. Eventually in 1981, a VER was negotiated that limited sales to 1.68 million units per year with subsequent renewals occurring at higher volumes. However, the ceiling, at 2.3 million units per year, has not been reached since 1987, largely because Japanese manufacturers have shifted production to the United States, thus avoiding the limit.

Though narrowly successful in achieving their limited aims, these sector-specific talks have pleased no one. Liberals in both countries assail them for violating free trade and legitimating other nontariff barriers that interfere with market efficiency and lower global welfare. Consumers complain that U.S. NTBs, which were estimated to reduce American manufactured imports by about $50 billion in 1983 (around a quarter of actual imports), raise prices while protecting inefficient industries.[29] Japanese exporters contend that they are being punished for their own efficiency; the American firms they compete against feel that the protection offered is inadequate.

Critics fear that these gray-area measures undermine international institutions, observing that the WTO cannot adequately police—or even document—agreements that are informal, unwritten, and, technically speaking, voluntary. A GATT review identified forty-seven such arrangements, but the United States denied that many of these exist. Efforts to achieve a standstill of further policies that contravened the letter or spirit of GATT or rollbacks of existing violations were centered on the United States (which accounted for about half of the protests lodged). These developments have been especially distressing because as national policies have skirted the international institutions that constrain protectionism, nontariff barriers have mushroomed. Already more than a quarter of the imports of industrial countries are covered by NTBs, including 36.1 percent of agricultural goods and 16.1 percent of manufactures.[30] The result must be lower levels of trade and reduced consumer welfare.

Moreover, these arrangements dangerously politicize trade. This not only favors nations with greater bargaining power rather than those with superior legal arguments, but it also invariably engenders tensions among trading partners, none more prominent than those between the United States and Japan. Still, so long as the two nations cannot agree on either the general principles of what constitutes fair trading practice or the specific facts of the individual cases, no better means of resolving conflicts is evident.

Recent trade disputes

In the 1990s, the central issues in American-Japanese trade disputes have centered around the claims of each nation that the other denies it market access. The United States contends that its import barriers, described earlier, are necessary to counteract the unfair trading practices imbedded in Japan's systematic mercantilism. Japan denies that the failure of U.S. products to penetrate Japanese markets is caused by Japanese government policy and accuses the United States of preferring liberalism only in sectors it dominates while adopting ad hoc mercantilism whenever that would suit its interests.

The most heated trade tensions have revolved around American complaints about access to Japanese markets, even though liberal theory suggests that the main losers from Japanese import restrictions are Japanese consumers. For example, Japan's rice market is very heavily protected by quotas, and the United States is the second largest rice exporter in the world. In 1985, Japan produced and consumed about 15 million metric tons of rice at a total cost of about $21 billion. That same volume was worth less than $3 billion at prices prevailing in the United States and other global markets. Thus if free trade would drive rice prices in Japan to global levels, the increased sales of rice exporters (in the United States and elsewhere) might benefit them by $3 billion but would benefit Japanese consumers by closer to $18 billion.[31] In manufacturing, where NTBs on U.S. products are estimated to be equivalent to a tariff rate of about 25 percent, complete trade liberalization might increase Japanese imports of U.S. products by $10–$15 billion annually, but these estimates are quite speculative.

As we have seen, however, these seeming losses are balanced by other benefits from the standpoint of the Japanese consumer. Thus, contrary to liberal theory, the loser in American-Japanese trade has been seen as the American worker, not the Japanese consumer. As a result, foreign pressure has played an unusually large role in shaping Japanese trade policy, with dispute resolution attempted at the unilateral, bilateral, and global levels. Unilateral efforts include Japanese initiatives in 1985 to designate October as import-promotion month, MITI's adoption of the motto "Spread friendship worldwide by promoting imports," and Prime Minister Yasuhiro Nakasone's urging each citizen to buy $100 worth of U.S. products.

At the global level, periodic attempts have been made to coordinate economic policies that produce trade disequilibrium, especially by the **Group of Seven** to stabilize the yen-dollar exchange rate. However, the WTO, which has been the most effective agency for dealing with other trade disputes, has been unable to deal with American complaints that Japanese markets have been effectively closed. In particular, WTO rules do not prescribe a remedy for the chief American complaints. Although GATT permits tariffs to protect domestic producers against imports that benefit from export subsidies by foreign governments, nations cannot use export subsidies to countervail foreign subsidies to import-competing industries. Thus, the United States could obtain no relief if American firms are prevented from exporting to Japan by subsidies to Japanese domestic firms. Nor could direct action be taken when export subsidies affect competitiveness in some third market. In both cases, the injured party could seek relief by appeal to the GATT Subsidies Committee, but in practice bilateral negotiations usually occurred instead. The WTO is intended to correct these deficiencies, but recent American actions to bypass its procedures suggest that even its chief sponsor doubts the effectiveness of dispute resolution by global institutions.

Indeed, most efforts to resolve trade conflicts between the United States and Japan have involved bilateral negotiations, mostly because they can more easily deal with the specific issues of market access that American trade officials attribute to Japan's unique economic structure and unusual consumer behavior. GATT was designed principally to reduce the overt barriers to trade commonly erected by all governments, but formal trade barriers like tariffs or quotas have ceased to play the major role in limiting American exports to Japan. Even direct government subsidies and technical barriers, which the WTO can address, have receded in recent years. Instead, American trade officials now focus their complaints on the private behavior of private actors and on the so-called structural impediments to trade that help shape that behavior. In doing so, they encounter more than the routine differences of opinion between nations that can usually be bridged by compromise—they confront a chasm formed by different philosophical positions concerning the fundamental dilemmas of trade.

Simply put, Japanese consumers and businesses appear to prefer domestic to foreign products. Japanese negotiators point out that the government is powerless to force consumers to demand imports, since consumer tastes cannot—and should not—be controlled by legislation. After all, they note that consumer freedom is an essential cornerstone of capitalism because it motivates the business competition that makes market-based allocation efficient and guarantees that citizen welfare will be maximized. They insist that the responsibility to reduce the bilateral trade imbalance resides in the private sector, principally with American businesses, which must either improve their products, tailor them more effectively to Japanese tastes, or market them more skillfully. Free trade, they contend, already exists.

This stance frustrates Americans, who insist that a refusal to buy foreign products cannot be considered fair trade whether or not it conforms to classical definitions of free trade. Moreover, American negotiators point to a number of structural impediments that prevent Japanese consumers from realistically comparing domestic to foreign products. For example, the inherently exclusionary keiretsu arrangements act as formidable barriers to the entry of foreign firms, and the notoriously inefficient structure of Japanese retailing makes it difficult for foreign products to compete. One study estimates that for various reasons, the prices of selected U.S.-made products are about 70 percent higher in Japan than in the United States.[32] Thus it is hard not only to generate the kind of free trade that the United States seeks but even to establish whether free trade exists when the very meaning of the term is contested.

These structural impediments to trade produce a conundrum in American efforts to open the Japanese market to U.S. firms. Eliminating formal trade barriers is an inadequate negotiating goal because it will leave intact those structural features of the Japanese political economy that tend to diminish imports. Standard approaches are no solution when a nation impedes trade through a societal rather than a state-based policy apparatus. However, any effort to attack these structural impediments forces a stark confrontation with trade dilemmas involving national autonomy and the preservation of alternative values. After all, asking for fundamental reform of the Japanese retailing system is equivalent to asking Americans to eliminate shopping malls.

As a result, negotiators have struggled with a variety of approaches to these inherently tendentious issues with very limited success. The most farreaching negotiations were the structuralimpediment-initiative (SII) talks, initiated in 1989. In attacking the structural arrangements that affect trade, these talks laid bare the dilemmas that arise whenever trade is linked to other aspects of national life. For example, the U.S. list of structural impediments to trade included Japanese savings and investment patterns, land policy, the distribution system, exclusionary business practices, keiretsu relationships, and pricing mechanisms. It was even suggested that because narrow Japanese roads discriminated against large American cars, they should be considered an unfair barrier to trade. The Japanese identified the chief impediments to imports of American products as the lack of U.S. investment in quality production methods, deficient worker training, and the poor American educational system. With an agenda like this, it is not surprising that the negotiations were acrimonious and unproductive.

Progress has been somewhat better when negotiations have focused on specific sectors of interest to potential American exporters, most notably telecommunications and electronics, forest products, medical equipment, pharmaceuticals, and, most recently, auto parts, air transport, and photographic supplies. In a series of so-called framework talks that covered automobiles, insurance, medical technology, and telecommunications, the United States sought to shift the focus away from formal trade barriers (because they are not the principal problem) and away from particular structural impediments (because they are difficult to measure or even identify with clarity). Instead, the United States has placed pressure on Japan to set numerical targets for imports by establishing "temporary quantitative indicators," a prediction of "what would happen in a particular sector if Japanese businesses and consumers made purchase decisions on the sole basis of commercial considerations."[33] The United States could then leave it to the Japanese government to find a way to import that quantity of American goods, thus shifting the pressure to identify and eliminate the unofficial import barriers to the Japanese government.

Japan has resisted, seeing this approach as a thinly disguised quota that smacks of managed trade—a direct conflict with America's professed commitment to free trade. The difficulty of papering over huge philosophical differences through such a voluntary import expansion (VIE) is exemplified by the semiconductor arrangement in which the Japanese government publicly stated that it "expected" that 20 percent of the semiconductors used in its computer industry would be imported from foreign firms (mostly the United States). However, the United States contended that this agreement should be considered a guarantee, and Japan rejected that interpretation of this "expectation." Thus, this approach, while sidestepping the most dramatic national sovereignty issues, invites misunderstanding and violates liberal precepts.

The slow pace of U.S.-Japanese trade talks

The two sides have been somewhat more successful in agreeing on quantitative measures of some structural impediments to trade. For example, in the auto area, the United States monitors the number of Japanese auto showrooms displaying American cars; Japan counts the number of American companies teaching the Japanese language to sales personnel or conducting seminars on how to do business in Japan.

However, U.S.–Japanese relations reached a new low in 1995, when the parties could not agree on provisions to increase Japanese purchases of American car parts. At this time the auto sector accounted for more than half of an escalating bilateral trade deficit. In frustration at the slow pace of negotiations, the United States announced plans to impose a 100 percent tariff on all Japanese cars priced above $30,000, which accounted for about $6 billion in sales in 1994. Japan, supported by the EU and most private economists in the United States, appealed to the WTO, claiming the retaliatory action brazenly violated the fundamental principles and specific rules of the WTO, which the United States had itself ratified several months earlier.[34] Although American actions were consistent with U.S. law, they clearly violated the obligation to use the WTO's dispute-resolution mechanism, designed for exactly this purpose. The stakes were high. As an American professor of international law put it, "America is flouting the core and central obligation since the beginning of GATT. This is just about the worst possible way to launch the WTO." Indeed, continued American defiance would squander the hard-won benefits of the decade-long negotiations over the Uruguay Round, which created the WTO, and if the United States refused to accept the WTO's judgment, surely other nations would cease to be bound by it. Furthermore, as the deadline for the imposition of these sanctions approached in June 1995, many cross-cutting retaliations in other sectors, especially air transport, were announced by both parties. A full-blown trade war, complete with a collapse in the legitimacy of the international institution that might otherwise contain it, could not be ruled out. At the last minute, a settlement was arranged, but it was more a public relations achievement to allow both parties to save face than a compromise that actually settled any issues. Moreover, less than a week after this potential disaster was averted, a public brawl over color print film was instigated by the American firm Kodak and championed by the Clinton administration. The chief evidence for the existence of unfair practices was the claim that Fuji controlled more than three-quarters of the market in Japan, yet Kodak outsold them dramatically in every other national market in which they competed. Between 1993 and 1998, the Clinton administration negotiated 35 different trade agreements with Japan, mostly within particular economic sectors.

Conclusion: the future of American-Japanese relations

[...]There is some evidence that the problems in American-Japanese relations may be self-limiting. The Japanese priority on exports has diminished, and they now constitute a smaller share of GDP than in the United States. Japanese export performance has grown only at about the pace of its overall macroeconomic growth, which has been slowing, since the late 1970s.

Moreover, most analysts see a convergence in the two systems as the inherent limitations of the Japanese system generate both internal and external pressure to harmonize Japanese practice with that in the rest of the developed world. Japanese citizens who work longer hours and face higher prices than workers and consumers elsewhere are tiring of the sacrifices. Japan has discovered that production cannot grow indefinitely without a greater increase in consumption. [The long Japanese recession of the 1990s resulted partly from weak domestic demand associated with high savings rates and partly from weaknesses in the banking system that also had roots in the huge volume of savings. Thus, Japan has become less resistant to American pressures to deregulate its economy, though some of the changes have themselves contributed to Japanese troubles. For example, the gradual decline of life-long employment has increased worker anxiety about job loss, leading to an even greater propensity to save rather than spend.] At the same time, the United States has discovered that consumption cannot grow unabated without more energy directed toward production. In some areas American firms are moving toward the Japanese: in worker empowerment, just-in-time inventory practices, total-quality management, and greater integration and partnership among firms.

However, trade issues remain especially difficult for Japan because they dramatically expose the dilemmas involving distributional issues, effects on the state, and the trade-off between alternative values. Liberalization in general has been a divisive force in Japan, increasing the role of foreigners in a traditionally xenophobic society, diminishing the role of the bureaucracy, eroding the communitarian vision of the economy, and bringing into the open the conflicts among the interests of firms, consumers, and the government, between economic and political considerations, and between domestic and international goals. As a result, the consensus among policymakers responsible for the coherence of policy during the era of Japan, Inc. has dissolved in recent years with some agencies, such as MITI, favoring liberalization and others, such as MOF, more often opposing it.[35]

Still, convergence may be the ultimate answer to defusing trade tensions that originate in different economic policies, which in turn result from different values and economic theories, different conditions in markets, and different balances of political power in the two countries. The alternative, discussed in Chapter 6, is to use regional arrangements like the EU or NAFTA to encourage trade between similar nations and discourage trade among dissimilar ones.

Endnotes

1. Lydia Saad, “Americans Support Active Role for U.S. in World Affairs” April 1, 1999, Gallup News Service.

2. Gallup poll, May 1999.

3. Because of the larger U.S. market, American dependence, in percentage terms, is smaller: In 1997, less than 10 percent of U.S. exports went to Japan, and about 15 percent of U.S. imports were from Japan. See *Annual Report 1998* (Geneva: World Trade Organization)

4. Quoted in Steven Schlossstein, *Trade War: Greed, Power, and Industrial Policy on Opposite Sides of the Pacific* (New York: Congdon and Weed, 1984), p. 4

5. Quoted in Jon Woronoff, *World Trade War* (New York: Praeger, 1984), pp. 144–145.

6. Some argue that these unusual bilateral imbalances simply reflect the comparative advantage in manufacturing inherent in Japan’s unique factor endowment of abundant capital but few natural resources. Critics suggest that protectionism is responsible for the unusually small penetration of the Japanese manufacturing market by foreign firms (about 1 percent in the early 1990s).

7. Charlie Turner, *Japan’s Dynamic Efficiency in the Global Market: Trade, Investment, and Economic Growth* (New York: Quorum Books, 1991), p. 104.

8. Although global production of automobiles nearly tripled between 1960 and 1990, American production was almost unchanged. Thus, the American share of global production fell from over 51 percent in 1960 to 19 percent in 1990. For greater details, see Peter Dicken, *Global Shift: The Internationalization of Economic Activity*, 2nd ed. (New York: Guilford Press, 1992).

9. List also noted that a trailing nation typically feels bitterness toward the dominant nation, especially in response to its exhortation for more liberal policies. Given the reaction of the United States, it appears that a declining power accepts the loss of its preeminent position with even less grace than a trailing nation accepts its long-standing status as a second-rate power.

10. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (London: J. M. Dutton, 1910), p. 439.

11. Ibid., p. 437.

12.Stephen D. Cohen, *An Ocean Apart: Explaining Three Decades of U.S.-Japanese Trade Frictions* (Westport, Connecticut: Praeger, 1998), p. 5.

13. Quoted in Woronoff, *World Trade War,* p. 230.

14. In 1955, Japanese output per worker was one-tenth of the U.S. level, but it reached 65 percent by 1985. See Turner, *Japan's Dynamic Efficiency,* p. xi.

15. However, in the early 1990s the U.S. government funded more than twice as large a share of R&D as the Japanese government, 44 percent to 20 percent. Of course, the priorities were different: Sixty-six percent of that was for defense in the United States but only 5 percent in Japan.

16. Takatoshi Ito, *The Japanese Economy* (Cambridge: MIT Press, 1992), p. 203.

17. C. Fred Bergsten and Marcus Noland, *Reconcilable Differences? United States Japan Economic Conflict* (Washington, D.C.: Institute for International Economics, 1993), p. 7.

18. David B. Audretsch, *The Market and the State: Government Policy Toward Business in Europe, Japan, and the United States* (New York: New York University Press, 1989), chapter 4.

19. Ito, *The Japanese Economy,* chapter 7.

20. Ibid., p. 190.

21. See http://www.ustr.gov/releases/1999/06/99-49.html

22. Another result is that unemployment is very low in Japan, which may partially explain why fiscal and monetary policy tends to be less expansionary than in the United States, where slack demand causes businesses to lay off workers. Because [...] unemployment depresses the entire economy, it generates strong political pressure for stimulative macroeconomic policy, including budget deficits.

23. Identification of these technical barriers involves a subjective component, however. For example, defenders argue that demanding safety standards are not deliberate protectionist devices but rather an appropriate adaptation to a Japanese legal system that makes product-liability lawsuits extremely rare.

24. Economies of scale are especially significant in small markets and where substantial learning occurs during production. For example, in the large commercial aircraft industry, production costs per plane decline by about 20 percent with every doubling of volume. But only one or two firms can benefit from these economies of scale because the total global market is less than 500 planes per year. See Gernot Klepper, "Industrial Policy in the Transport Aircraft Industry," in Paul Krugman and Alasdair Smith, eds., *Empirical Studies of Strategic Trade Policy* (Chicago: University of Chicago Press, 1994), pp. 101–129.

25. Of course, the United States also has an industrial policy, though it is less sophisticated, extensive, and coordinated than Japan's. Its elements include tied foreign aid, military sales abroad, subsidized power and water, government R&D, and government procurement policies.

26. Governments could impose restraints on imports whenever domestic industries were threatened, but the standard of injury and the method of remedy they could use varied. If the increase in imports resulted from market forces, "serious" injury had to be proven and the nation increasing protection was required to compensate with reduced protection in other sectors. If trade results from subsidies offered by foreign governments, the injury must be only "material," and nations need not offer compensation for tariffs that balance the subsidies.

27.The USTR reported that from 1986 to 1998 524 anti-dumping investigations were initiated and 277 anti-dumping orders were imposed. Over the same period 132 countervailing duty investigations were initiated and 70 orders imposed.

28. Exporters usually prefer voluntary export restraints administered by the exporting government rather than quotas administered by the importing government. Both usually involve charging firms a fee for the privilege of exporting, but in the former case the revenue goes to the exporting rather than the importing government.

29. Cited in Bergsten and Noland, *Reconcilable Differences?* p. 71.

30. See Julio Nogues, Andrzej Olechowski, and L. Alan Winters, "The Extent of Non-tariff Barriers to Industrial Countries' Imports," in J. Michael Finger and Andrzej Olechowski, eds., *The Uruguay Round: A Handbook for the Multilateral Trade Negotiations* (Washington, D.C.: World Bank, 1987).

31. Turner, *Japan's Dynamic Efficiency*, p. 68.

32. See ibid.

33. Advisory Committee on Trade Policy and Negotiations, "Major Findings and Policy Recommendations on U.S.-Japan Trade Policy," 1993, Washington, D.C. Quoted in ibid., p. 19.

34. Ironically, the biggest loser would have been Mazda, which is partially owned by Ford, and the biggest beneficiaries Germany's BMW and Mercedes-Benz.

35. See Leon Hollerman, *Japan, Disincorporated: The Economic Liberalization Process* (Stanford: Hoover Institution Press, 1988).