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THE UNITED STATES AND JAPAN: COMPETITION IN WORLD MARKETS: POLICY ALTERNATIVES FOR THE UNITED STATES

By William V. Rapp

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INTRODUCTION

Japan and the United States are the world’s two largest economies, accounting for over $3 trillion in gross national product (GNP) and over $400 billion in world trade. Their impact on the world economy, on trade patterns, on foreign exchange markets, on currency flows, in fact on our economic future, is profound. Yet, these two countries have contrasting postwar economic developments as a direct result of different economic policies. In an interrelated world, these developments affect world trade and other countries which compete with Japan and the U.S. More importantly, the adverse consequences of contrasting postwar policies and different competitive positions are presently exacerbated by a worsening of already poor U.S. economic policy in the face of superior Japanese competition. This competition is for global market share across a wide range of industries in which import, export, and investment strategies all play an important role nationally and corporately. In the near term, this competitive situation will continue to result in rising tensions between the two countries and in an unstable world trade and currency environment until some basic U.S. policy changes are made.

United States-Japanese competition in world markets is obviously a broad-gaged subject. This paper examines the problem in terms of the impact of policies and perceptions on global competition and apparent trends in competitive dynamics, and analyzes how U.S. strategies and policies might influence those trends. The paper also discusses the theoretical basis for Japan’s continuing economic success and outlines an alternative framework for U.S. economic policy.
JAPAN AS A SUPERIOR COMPETITOR

The United States has lost its position as the world’s leading industrial power by not meeting the competitive challenge of a better organized, more productive, and faster-growing economy, Japan; 1978 was the Watershed Year. At an average monthly rate of 190 Yen=one dollar, per capita GNP of $9,500 essentially equaled the U.S. ($9,600), while per capita GNP from manufacturing was 50 percent higher. Japan has an industrial trade surplus of $77 billion compared to a U.S. deficit of $4.8 billion. Her manufactured exports totalled $96 billion, essentially the same as the U.S.’s $100 billion. Although America has twice the population and GNP, manufactured shipments were also equivalent. In addition, her absolute gross level of domestic capital formation was comparable at $340 billion, versus 328, was private machinery and equipment investment ($144 billion versus $148 billion). Investment rates about twice America’s and higher real growth rates mean that Japan will clearly pass the United States as the world’s leading industrial power in the early 1980’s despite any exchange rate fluctuations.

Current U.S. policies have been woefully inadequate to meet its obvious competitive problem. Its bilateral trade deficit (excluding freight and insurance) which was $5.5 billion in 1976 rose to $11.8 billion in 1978. In the same years, Japan’s overall trade surplus was $9.9 billion, and $24.7 billion; conversely, the U.S. overall trade deficit was $7.4 billion and $30.9 billion.

Examining manufactures alone, the situation looks even bleaker since almost all Japan’s exports, though not all U.S. exports, are manufactures. The United States overall trade surplus in industrial goods of $20.5 billion in 1975 deteriorated to a $4.8 billion deficit in 1978 while Japan’s overall surplus improved from $44.3 billion to $77 billion. The bilateral situation was similar, as Japan’s manufactured goods surplus rose from $7.7 billion to $19.2 billion.

Nor should we take comfort from the 1979 decline in Japan’s trade surplus due to rising energy, raw material, and food prices and subsequently a falling Yen. Japan’s absolute annualized savings and investment levels remained comparable to the United States—$325 billion for total capital formation and $154 billion for plant and equipment, versus $368 billion and $162 billion for the U.S. Her manufacturing trade surpluses globally and bilaterally were $72 billion and $18.8 billion respectively versus $77 billion and $19.2 billion in 1978, essentially no change on a bilateral basis. The increased price of oil accounted for a $12.3 billion swing in Japan’s import bill, and food and raw materials another $11.5 billion. Net dollar export prices were up 10.2 percent annually, less than the U.S. at 13.7 percent. The U.S. global surplus in manufacturing was only $8.5 billion. Average monthly Yen rate for 1979 was $222.

U.S. COMPETITIVE DIFFICULTIES

De facto U.S. postwar industrial and economic policies in themselves probably would have led foreigners to exploit U.S. competitive weakness, but Japanese firms, assisted by favorable government policies, have been particularly successful in doing so. This can be beneficial to the United States if it focuses attention on competitive
problems, the need for policy change, and a more successful model for competitive development. However, it is also worrisome given the probability of increased tensions, continued U.S. weakness, and more pressures on the dollar if sound new policies are not rapidly developed.

Such tension and U.S. weakness also have serious strategic consequences for America’s important military and political relations. If the U.S. defense budget must grow 5 percent per year in real terms to maintain or recapture strategic equilibrium with Russia, and if the economy continues to stagnate, the result will be intolerable internal allocation pressures by the end of the decade. Thus, the 5 percent goal may not be reached, resulting in a serious decline in our relative defense posture and U.S. world leadership. This in turn may force the Japanese to reevaluate their own position. Indeed there are recent public policy statements that indicate they already are. Fortunately, the policies needed to increase growth and to make the U.S. more competitive would, at the same time, alleviate many domestic economic ills such as stagflation, unemployment, and competing social objectives as well as several international problems. A more productive, more competitive, more efficient economy would lessen inflationary pressures, create more jobs and provide a larger, faster growing economic pie to support national goals, while reducing current and potential problems with Japan and other countries.

The United States must be able to compete with Japan for global markets if it is to retain the economic base needed to remain a dominant world power. This is an important national objective. The benefits more than justify it. Japan needs a strong and predictable ally. The United States needs better Japanese relations, an improved payments balance, a stronger dollar, and reduced world economic tensions. To achieve this, the United States need not remake itself in Japan’s image. Profound historical, political, and cultural differences prevent this. The economic fundamentals required, though, are actually straightforward and within our grasp. Further, there is little in the Japanese success formula that is innately Japanese. The political will and educational follow-through are what is difficult, and we must recognize that following sound competitive principles does not make us Japanese. Still, the only adequate response to the competitive challenge is a fundamental political economic reorientation: a substantial resource allocation shift towards investment, trade, and technology and a change in regulatory policies and in the sharing of regulatory costs. This, in turn, must be combined with an increased appreciation by American business of the importance of global market share.

The reasons for our bilateral and global imbalances with Japan are the same. Many major U.S. industries are declining competitively. World trade in the manufactured goods primarily produced by major industrial countries is dominated by a few large multinational companies which compete for the same markets. In the United States, some 250 firms account for over 75 percent of U.S. exports. In Japan some 200 firms (not including trading companies) account for roughly 64 percent of exports. These companies compete for sales in the United States, in Japan, and in third markets. A loss of export sales by General Electric or General Motors to Hitachi or Toyota in Saudi Arabia has as much negative impact on the U.S. payments balance as a loss in the United States or Japan. The United States has lost such sales. To
decrease the trade deficit, major U.S. exporters must be more competitive domestically and internationally, and must understand the strategic use of foreign investment. But they also need government assistance and incentives.

Japan sells little that we do not or could not make. Yet we have a massive bilateral deficit in manufactured goods, with no discrimination against U.S. manufacturers in the U.S. market. We suffer from excessive imports and declining domestic competitiveness in addition to any difficulties exporting to Japan. A Boston Consulting group study for the U.S. Treasury indicates that the United States has lost market share in Japan to the European Economic Community (EEC) and to more developed Asia as well. Yet, those U.S. firms that have been successful in Japan have all had global strategies (e.g., International Business Machines, Texas Instruments, Boeing, Caterpillar, and Coca-Cola). Those U.S. industries that have had competitive problems, often resorting to “fortress America,” have not had global strategies (e.g., steel, shipbuilding, heavy power generation, and consumer electronics). The former have often used a proprietary position or technology or both to force entry into Japanese markets, the latter have not.

The lessons are clear-cut. Markets for traded commodities are global and decreased competitiveness is reflected in all markets, domestic and export. The impact on the U.S. deficit is doubled. We lose export earnings, and increase imports. Also our major corporations are weakened because the competitive problem is continuous; increased sales improve a competitor’s productivity. The largest Japanese firms with the largest domestic share also have the largest export share. The marginal U.S. firm competes with the most successful, most efficient Japanese producer. The small U.S. firm’s lost market share in turn helps develop the large Japanese firm’s global competitive position against the leading U.S. producers. Anti-trust policy that prevents declining U.S. industries from rationalizing production exacerbates this problem. The biggest Japanese inroads into U.S. domestic and export markets are in industries where economies of scale in production and/or marketing are important, and where there are small inefficient producers, or major producers serving only the U.S. market.

However, just as Japan was able to develop viable economic policies and strategies out of the necessities she faced at the end of the war, it is certainly possible for U.S. official and businessmen to develop an appropriate and coherent set of competitive and strategic policies to offset actions that have raised user costs and lowered normal productivity increases, and to improve on historical performance as well. But to do this correctly, the United States must have a good understanding of Japan’s competitive thrust and its probable future direction, as well as a knowledge of the economic theories and policies underlying Japan’s economic success.

**AN EVOLUTIONARY PERSPECTIVE OF THEORY AND POLICY**

Over time, economic theory must reflect reality or subsequent policy will be increasingly ineffectual or even counter-productive in achieving national economic goals. Traditional neo-classical and Keynesian analysis is now less and less appropriate as a basis for formu-
lating policy or national economic strategies. The United States and world economies have changed dramatically since the 1930’s so that underlying assumptions of traditional neo-classical and Keynesian theories no longer reflect the realities of the competitive environment. These theories were developed from real world economic situations substantially different from those existing today. Classical theory emphasizes perfect competition among small, similarly sized units with no economies of scale and a common cost structure. In turn, wages and prices are assumed flexible and fully responsive to specific demand and supply pressures. This situation may have reflected nineteenth century England, but it does not typify the present world economy. At that time, there was surplus labor available from agriculture and industrialization was dominated by light industry, particularly textiles. But in today’s modern industrial economies, services and industry are dominated by large firms operating on a worldwide basis where economies of scale in production, marketing, and distribution differentiate firms from their competitors in terms of size, efficiency, and profitability. Competition is oligopolistic and global.

It was the shift in industrial structure in the early twentieth century from light to heavy industry within the major industrial countries like England, the United States, Germany, and Japan that helped alter the ingredients of successful economic policy. Under classical assumptions of price and wage flexibility, supply was thought to create its own demand. (This was Say's law of markets.) Initially this was done by creating jobs and income due to investment expenditures. Longer term, capacity usage was assured through lower prices; that is, the supply curve shifted to the right and this, in turn, created secondary effects as prices fell via substitution demand and rising real incomes.

Under this scenario business downturns were inevitable but also temporary. In a recession, prices would fall and a certain number of firms would go out of business, eliminating excess supply. Wages would also fall, but due to declining prices, real wages would rise until demand and supply were again in equilibrium. On the monetary side, reduced investment levels would lower interest rates until capacity and inventory additions were again attractive. This also helped bring demand back to full-employment equilibrium. The economy was thus seen as self-correcting and as moving from one full-employment equilibrium to another along a growth trend, with capacity and inventory expansions being the disturbing influence. The difficulties in solving or formulating specific economic analytical problems in terms of a general equilibrium approach meant that most economists, for practical policy purposes relied on partial equilibrium analysis. Analytically, certain major variables like investment were changed while others were held constant (ceteris paribus). Overall this theoretical and policy approach seemed to work well in the relatively simple, laissez-faire, small-firm, nonunionized environment of the day. Indeed laissez-faire policy and its theoretical base as conceptualized from observations of the economy were self-reinforcing since the economy did appear actually self-correcting with little government interference.

Classical economic theory and policy emphasized what one might call the real or physical economy at the micro level—growth and supply—rather than the monetary or demand economy at the macro level. The latter was in many analyses considered just a veil with little
effect on the real allocation of resources as prices and wages responded
to the physical capacity available to supply goods and to the amount
of money in circulation. From this viewpoint, prices were determined
by multiplying the "Marshallian K" (the velocity of money) times the
amount of money in circulation divided by the real transaction level.
But growth implies change, and since economies alter their structures
over time, the validity of particular economic models and their
associated policies also change. Thus, classical theory and its associated
laissez-faire policies gradually became less appropriate in dealing with
certain economic problems.

The growth of light industry created demand for heavy industry
such as steel, machinery, automobiles, and shipbuilding where econo-
 mies of scale and the organizational benefits of large corporations were
manifest. At the same time, skilled laborers were hired on a more per-
manent basis and unions came to exercise greater influence. Further,
user capital costs, profitability, and capital formation began to have
more impact on the real allocation of resources and business success.
Therefore, as the relative importance and size of heavy industry grew,
these developments came to dominate the economic environment.
Administered prices, lumpy investments, and sticky wages soon sub-
stituted for the small-scale flexibility of the original classical environ-
ment.

In this context, supply did not necessarily create its own demand as
prices and wages might not fall sufficiently to clear markets. Large
corporations could maintain their existence by laying off workers and
cutting back production levels. Yet, substantial excess capacity would
continue to exist. Falling interest rates and an increased money supply
would then not bring forth new investment, especially as the time
value of, and transactions demand for, money set a floor under interest
rates. (This was Keynes' liquidity trap.) In fact, the "Marshallian K"
or the velocity of money was found not to be fixed and price flexibility
was no longer sufficient to automatically increase private consumption
or investment demand.

In this environment, Keynes correctly analyzed that massive
government expenditures and deficit spending were necessary to
generate demand or alternatively to use up excess desired savings.
This was the origin of demand management and the increased reliance
on government policies affecting the money economy at the macro
level as opposed to letting the real economy function with little gov-
ernment influence. The assumption was if sufficient demand was in
place, the traditional classical responsiveness of supply would be
forthcoming. Essentially this policy worked, and was a proper re-
sponse to changed economic circumstances. Monetary policy became
part of this demand management emphasis as a way to control in-
vestment demand via interest rate levels. This was also true of for-

eign exchange rates since devaluation lowered export prices, increased
import prices, and so raised the demand for a country's products.
Therefore, rising government expenditures, competitive devaluations,
and low interest rates were all tried during the 1930's.

Gradually, demand or money management theories and policies
became the accepted wisdom with little real thought for supply or
the real economy. After all, in a major depression there is little concern
about excess demand. But, clearly, constantly shifting the demand
curve right raises prices and is inflationary. Increasing government
expenditures, reducing taxes, or devaluing the dollar does nothing to increase the available supply except through the inducement of higher prices. At the same time, attempts to restrict demand growth periodically via monetary policy by raising interest rates to curb investment have been self-defeating; in the short term, these policies raise capital costs, aggravating inflation, and in the long term they reduce available capacity. Alternatively, reducing government expenditures or raising taxes has proved politically unpalatable.

In addition, demand management policies have lost sight of the fact that it takes time to expand capacity, that is, for supply to respond to increased demand. Further, the oligopolistic competition and business structures partially responsible for the problems of the 1930's have continued or even become more prevalent. Prices and wages are still not very flexible downward in a recession. Thus the level of unemployment that is politically tolerable is not sufficient to bring about long-term price stability. In sum, demand management policies can underwrite demand levels sufficient to prevent major recessions, but practically they cannot assure long-term price stability at acceptable levels of unemployment.

The obvious solution to this dilemma is an approach in which supply growth and reduced prices are encouraged via competition, plant modernization, increased productivity, and expanded capacity. That is, the supply curve should be shifted to the right while demand management assures this capacity will be utilized. This implies a more balanced policy in which there is concern for supply and demand, for both the real and money economies at all levels. It is not enough to assure adequate demand if the economy is not prepared to meet it efficiently over time. Yet Americans have shied away from supply management because some have felt this meant too much government control in running the economy, along Russian lines, but this position is ridiculous. Already a plethora of government regulations have impacted the real economy. Unfortunately, though, they have tended only to raise costs and restrict supply, further aggravating the inflation and unemployment problems, because they have not been tied in with any overall economic policy. Since government interference is already a fact, at least it should be intelligent; one can certainly indicate directions and offer incentives without controlling specific business activities. The best and most successful real world model of this kind of balanced approach is, of course, Japan. Here supply and demand management are properly treated like two parts of a scissors. If the U.S. wants to cut a successful national economic pattern of price stability, low unemployment, balance of payments equilibrium, a stable dollar to meet its security and other obligations, and reasonable growth to fund people's rising aspirations, it needs both policy blades and could profitably learn from Japan's experience. The current U.S. wisdom maintains there is fundamental conflict among these goals; but in fact a two bladed approach can achieve them simultaneously.

**Japan's Balanced Approach to Competitive Dynamics and Economic Policy**

At the end of World War II, Japan's economy was devastated, and her government faced the challenge of providing a living for an already large population further expanded by returning soldiers and colonists.
With little arable land and few raw materials, this could only be achieved by developing an internationally competitive industrial sector which would not only supply domestic demand but could competitively export to pay for required food, energy, and raw material imports. Further, given the economy’s labor intensity, any upgrading of national income depended on becoming competitive over time in more capital and technologically intensive industries. These goals logically required the targeting of key industries and the achieving of high rates of growth and productivity. This scenario in turn would necessitate high rates of investment which, to be noninflationary, would require high savings rates. The Japanese government, therefore, undertook to change savings and investment rates through monetary, fiscal, and tax policy actions and to direct these funds initially towards industries like shipbuilding, steel, fertilizer, and power generation and later, as the economy grew and developed, towards chemicals, petrochemicals, autos, and computers. The government itself ran a fiscal surplus, increasing aggregate savings, while aggressive monetary policy encouraged the corporate use of debt financing, lowering after-tax capital costs to stimulate investment particularly in heavy industry. The result was a flexible financial system generating substantial savings that were readily allocated to high growth areas.

The success of these policies is well documented. (See above section: Japan as a Superior Competitor.) Japan achieved very high real growth rates and low unemployment rates with remarkable wholesale and export price stability. Yet this success raises many questions concerning the traditional assumptions of U.S. economists, who see long-term savings and consumption rates as relatively fixed due to institutional and cultural factors. In fact, these parameters can be changed over time given changes in policy incentives affecting savings and investment such as depreciation allowances, real after-tax rates of return, and government regulations. Japan did not have the luxury of looking at historical statistics in a relatively unchanged cultural environment to create a circular self-fulfilling prophecy. Japan had to increase savings and investment levels, and it did, from 20–25 percent of GNP in the early 1950’s to over 40 percent in 1973.

These dramatic changes in savings and investment rates radically altered the relative factor endowments between capital and labor; so that gradually Japan gained comparative advantage in more capital and technologically intensive industries, raising incomes and living standards. Therefore, it would appear that comparative advantage is not only variable over time but is subject to policy manipulation; that is, product cycles occur due to economic growth, and government can affect the speed with which they occur through policies affecting savings and investment and thus growth. Interestingly, in the early 1950’s, the Bank of Japan (BOJ) and the Ministry of Finance (MOF) argued that Japan should not try to develop an automobile industry because Japan’s comparative advantage was in light labor intensive industries such as textiles. They should, therefore, export textiles and

import autos. This was essentially the traditional Western Economic view using comparative statistics analysis, and probably reflected training at prestigious U.S. universities. Fortunately, MITI (The Ministry of International Trade and Industry) took a more pragmatic and dynamic view of where the economy ought to go and how it should get there. MITI won the debate.4

Yet, the government did not try to control the economy, but rather led it through incentives and logical persuasion.5 Perhaps the government had learned this lesson from its disastrous experience with attempts at rigorous economic control during the War and under SCAP (Supreme Commander, Allied Powers).6 In any case, general incentives to growth, investment, exports, price competitiveness, productivity improvements, expanding markets, and more growth were offered to all firms in an industry or sector, primarily via tax and monetary policy. The faster growing more successful firms benefited more from these incentives which further improved their performance and often led to rapid consolidation unopposed by antitrust policies. Further, high growth rates contributed to the fiscal surplus that was rechannelled into more productive investment. Japan predicted the current “incentive economics” theories by thirty years, and is living testimony to their validity.

Japan observed or recognized a competitive environment in which economies of scale in production, marketing, and distribution for capital and technologically intensive industries were a reality. Developing internationally competitive firms, therefore, required oligopolistic competition if costs were to be lowered and markets developed. Both government officials and businessmen recognized that global market share would affect profitability, growth, and competitiveness, domestically and internationally. Classical theory’s perfect competitor was not a reality in international markets. Thus it was not practical or effective to pursue financial or regulatory policies that favored perfect competition.

In essence, out of necessity, Japan recognized the implications of the changes in industrial structures that had occurred in modern economies and the dynamic possibilities this offered. In turn, Japan’s successful policies and strategies further changed the world’s competitive economic environment by establishing internationally competitive firms with high investment and productivity rates that priced aggressively to develop markets. But the key was that Japan’s policy makers in government, business, and labor developed their theories and policies from observations of the real world, rather than by manipulating existing theories. This is how they achieved their economic objectives, initially to survive, and later to raise living standards and the quality of life. This is what American economists and policy makers should learn from Japan—to look at the real economy first in order to develop a theoretical base. Then we can formulate the policy tools both regulatory and monetary (e.g., foreign exchange, interest rates, and tax rates) to bring about desired policy

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objectives. Further, we should probably follow Japan's example of viewing monetary, fiscal, and tax policies as functions of real microeconomic objectives rather than just pursuing preprogrammed monetary or fiscal responses in particular macroeconomic situations.

As an example, the current wisdom says that the only way to whip inflation is to cut back on Federal deficits and tighten the monetary screws to wring inflation out of the economy at unacceptably high levels of unemployment, despite the political difficulties. This view indicates our total involvement with demand management, and cogently illustrates the traditional policy problem described by the "Phillips curve," that is, the pitting of jobs against price stability. This proposal seems politically naive, given our postwar economic history of supporting employment. It also seems to reflect a Calvinist bent in conservative economists advocating this approach; that is, the Nation and the people must suffer to compensate for their past excessive living style and profligate consumption patterns. In fact, Japan's experience and policies, as well as common economic sense, indicate that we can have rapidly rising living standards, high employment rates, and price stability if we only maintain or generate high enough savings and investment rates so that productivity increases and more efficient supply capacity can meet the increased demand at stable prices. If the supply and demand curves move to the right together, price stability can be achieved at higher levels of output and employment. In sum, a policy balancing demand and supply can solve the policy dilemma of the "Phillips curve," and, like the two blades of the scissors, can cut an internally consistent and acceptable pattern of national economic goals.

Japan's balancing of supply and demand management has necessarily meant a conscious involvement and monitoring of the real microeconomy, the monetary macroeconomy, and their interaction. In practice, however, the emphasis has been first on real economic impacts such as establishing internationally competitive industries with real productive capabilities. Foreign exchange, fiscal, and monetary policies have supported these objectives through underwriting demand and providing required financial resources to fund noninflationary investment demand. These policies and objectives are also coordinated with regulatory policies affecting such matters as pollution and safety. At the same time, real economic policy is viewed as a dynamic process. This is because a policy based on changing an economy's structure and comparative advantage must recognize that the economy is continually evolving. Therefore, measures as to the appropriate target industries, industrial structure, and living standards are constantly being revised and upgraded. In sum, Japanese officials, businessmen, and labor leaders understand the need to plan and prepare for the economy's natural development. Currently this means phasing out of light and even certain capital, but energy-intensive, industries into more technologically sophisticated levels of production and employment (e.g., computers, semiconductors, telecommunications, software systems and engineering).

Japanese policymakers understand that the declining cost of technological transfer combined with the faster growth of light and certain energy uses in base materials industries in the less developed countries (LDCs) means that Japan is rapidly losing absolute and comparative advantage in these industries. But rather than oppose these
economic forces, Japan is trying both to encourage and cushion their impact. Imports are being encouraged to keep living costs low, but the government is also helping firms to scrap obsolete plant, to modernize, and to enter new industries. Firms are also investing overseas to maintain their export markets through lower cost production bases, while providing marketing, design, engineering, and equipment support. In this way firms can upgrade their employment on an intra-industry basis while globally maintaining their overall corporate competitiveness. Just as successful Japanese managers saw that exports extended the beneficial cycle of investment, productivity improvement, cost declines, competitive pricing, market expansion, and more investment once high domestic demand slowed, they now view foreign investment as a logical strategic extension to maintain global markets and to promote corporate development.

Since macro-economic results are generally made up of micro-economic events, the overall effect of these developments in the last few years has been to rapidly increase Japanese direct investment abroad. It also explains why the Japanese government wants foreigners to look at Japan’s basic balance of payments rather than its trade balance since Japan needs a trade surplus to fund both its deficit in services and its growing long-term capital outflow. Japan’s positive technology balance of payments with the LDCs is an adjunct of this evolution. Though the economy is currently in transition, ultimately the impact of these policies and Japan’s economic evolution will be to maintain the worldwide competitiveness of Japanese multinational corporations (MNCs), even though the direct source of production may be other countries. In effect, this represents the multilateralization of Japanese competition with the more sophisticated managerial, engineering, and production work remaining in Japan.

Simultaneously, with this continuous upgrading in employment opportunities and the quality of life, these policies will create a positive outlet for Japan’s excess savings. They will also reduce the trade surplus and pressures on the Yen as some export growth is shifted overseas. Monetary policy, foreign exchange controls, fiscal expenditures, and tax codes will be manipulated as before to achieve this scenario. Special reserves for overseas investment, subsidies for industrial restructuring, changes in foreign bond issue approvals, are already being used to keep the business cost of capital for foreign investment low and the Yen slightly appreciating. Further, because real savings and investment rates and thus real growth and productivity rates will continue to be higher than current U.S. levels, this competitive restructuring should take place rather smoothly at lower rates of interest and inflation than in the U.S. Simultaneously, real standards of living, employment opportunities, and Japanese global competition will rise more rapidly as well. Moving declining industries offshore naturally contributes to this beneficial cycle as fewer resources are channeled to low growth sectors. The overall growth rate, therefore, remains higher, and growth facilitates structural change.

High rates of saving and low user capital costs are, as in the past, the key to this restructuring since they make possible both high rates of domestic growth and substantial foreign investment without

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sacrificing continued competitiveness in basic strategic industries. An example of this fact is the contrast with the United States of the effect of wage settlements and government regulations on inflation. In the United States, government pollution and safety regulations have increased industry costs and decreased productivity. Because wage settlements are negotiated on the basis of anticipated, i.e., historically based, productivity improvements plus a cost of living allowance (COLA), the effective interaction of wage settlements and regulations has been an upward spiral in prices and nominal wages as productivity has fallen short of anticipated levels. Japan, on the other hand, has actually benefited from even stricter pollution regulations because mandated expenditures have used up excess desired savings, raising overall GNP growth levels while developing a new industry and new technology for which there is rising worldwide demand.

To compensate, the United States should allow expensing or very rapid write-offs of pollution-related expenditures. Tax credits might be considered to compensate for Japan's competitive edge. Currently 3 to 4 percent of U.S. GNP goes to all regulations, but it is only investing 17 to 18 percent compared to Japan's 30 percent. Competitively, America's economy and industry cannot handle the relatively higher diversion of productive resources, especially when one recognizes that the amount of investment available to increase productivity after replacement costs, housing and inventories is only 4 to 5 percent of GNP. Such tax policies would also force legislators to make the appropriate budget/benefit trade-offs for various regulations. But strategically this must be supported by more savings.

Given Japan's planned economic direction for the 1980's, the likely sources of global competitive friction with the United States and U.S. corporations are likely to be as follows:

1. World competition and Japanese liberalization in high technology manufacturing industries like computers, semiconductors, telecommunications, and aerospace where Japan will try to build on its existing strength in producing plant and equipment consumer electronics, and automobiles.

2. Future competition and the need for significant Japanese liberalization in high technology and/or knowledge (skill) intensive service industries like software systems, management services and systems, banking, and insurance. The issue of national treatment will probably be important here.

3. U.S. market competition with exports from Japanese investments in third countries like Brazil, Mexico, Korea, and Taiwan.

4. Competition from new, highly productive Japanese investments in the U.S. in mature industries where U.S. business in many cases has inefficient capacity (e.g., autos, TVs, and ballbearings).

5. Competition for global resources, including energy, though there is an opportunity to use Japanese capital resources to develop alternative U.S. energy resources to the economic, political, and security benefit of both countries.

Illustrating these trends is the apparent transitional strategy of Japan's steel industry. This industry, of course, formed the basis for Japan's competitive growth in the 1950's and 1960's through its competitive development and positive interaction with shipbuilding,
machinery, and, later, autos. Currently it is trying to keep its existing capacity competitive (it has 37 basic oxygen furnaces of over 2000 cubic meters capacity versus five for the U.S.) through more productive investments and modernization in Japan, such as continuous casting. But this is coupled with selling plant, equipment, and technology overseas. Japan's steel industry often takes an equity or management position as well. For example, in 1978 Nippon Steel had over $1 billion in engineering revenues, and Sumitomo provided technical assistance to U.S. Steel for its wide diameter pipe mill in Texas.

TOWARD AN ALTERNATIVE FRAMEWORK FOR U.S. ECONOMIC POLICY

How does the U.S. adapt Japanese approaches to U.S. institutions to solve its current economic problems? The following seems a constructive first step, given that current challenges have created opportunities for rethinking basic assumptions about economic reality.

The U.S. must begin to shift real resource allocation to achieve a more rational regulatory burden sharing and to improve savings, investment, technology, and productivity. Though resources will come from business, consumers, and government, the shift is highly dependent on government policies and initiatives. In addition, the U.S. needs a different conceptual framework for formulating economic policy analogous to Japan's which recognizes that:

1. Growth and economic change are basically beneficial.
2. Successful economic policy in a modern complex industrial society is a long-term proposition. Long leadtimes for major capital investments, retraining, and economic restructuring require long-term planning and consistent economic and regulatory policies.
3. Economies, industries, and markets differ and constantly change and develop, creating risks and opportunities. So policies must be both dynamic and industry specific. One firm or industry's difficulties or success can be masked by macro-economic variables such as the balance of payments or the unemployment rate. Yet, its performance can have significant political or strategic consequences as in the cases of Lockheed, Penn Central, Chrysler, or Youngstown Steel. Industries and firms are not homogenous in terms of factor inputs, economies, development stages, and so on. Policies, to be successful in the aggregate, must pay attention to such differences and yet interegrate them into an overall strategic framework that relies on incentives rather than legislative compulsion.

An already noted illustration of this is the Japanese government's approach to foreign investment, modernization, and industry rationalization which has combined nicely with Japanese corporate strategies in terms of multinationalization and controlling product evolution. Further, while comparative statics may offer a reasonable approximation of reality for policy purposes in a slow or negative situation like the 1930's, it is totally unsuitable to the high growth environment with large differentials among industries and countries that exist today.

This means that government should pursue selective favoritism according to strict criteria, promoting key emerging industries or those strategic for the economy and defense. Producing firms should be as efficient and internationally viable as possible. A service economy still needs an efficient and competitive industrial base. Supporting losers is expensive and counter productive. Some favoring of particular indus-
tries is inevitable. The United States should change its focal point, however, to favor those on the cutting edge of industrial development. This facilitates growth, competitiveness, and industrial restructuring. Declining industries with declining employment and relative GNP contribution should not be propped up by tariffs or quotas. Yet industry rationalization should not be blocked by anti-trust regulation as long as international competition will keep prices down. In addition, those firms that remain should be able to get the investment resources they need to remain productive and competitive. A large declining industry eats up productive resources at low rates of return. These are resources America cannot afford to waste. The United States must overcome its fear of corporate bigness and take a global competitive view. A large and growing world economy requires this, especially where economies of scale are competitively important. Theory must be dynamic, and policy must be thought through consequentially.

4. Markets are multinational. Thus policies must reward competitive success domestically and overseas.

5. Countries have different regulations so regulatory policies, including anti-trust, must be flexible and consider the cost competitive impact of each regulation.

6. The keys to long-run economic success are a high savings rate and high investment levels leading to solid growth, productivity improvement, low inflation rates, international cost competitiveness, and a strong currency. Therefore policies must promote saving and investment. Such policies need not take income resources away from any group, however, as some “zero-sum” society analysts have argued. They only need change the price incentives facing consumers as between savings and consumption. In this way, people by their own incremental consumption decisions will over time both raise savings and total real income.

7. Government interference in today’s complex society is inevitable but it should be limited and should emphasize direction rather than control. To accomplish its objectives, government needs to cooperate with business and labor.

This economic view of reality in turn can lead to a series of specific policies and policy recommendations such as: balancing the budget to increase savings; eliminating double taxation on dividends to lower business capital costs; introducing tax incentives to encourage international competition; allowing tax breaks to offset regulatory costs; and giving real after-tax rates of return on savings. Such measures will improve our competitiveness in world markets. In addition, such a viewpoint can help us to see clearly the inadequacies of those present policies (and their theoretical bases) that have been implemented to solve our present economic ills. This current policy group would include floating exchange rates, trade-related pressure tactics, promoting export consciousness, the present energy program, and the November 1978 and October 1979 dollar support packages. None of these addresses the fundamentals. They will not change investment levels, productivity, or resource allocation or long-term global market share. At best they offer time to improve investment, growth, productivity, and export competitiveness. At worst, they aggravate present difficu-

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cultures, leaving few options for future maneuvers. Because we do not live in a policy vacuum there are competitive time pressures. We cannot gradually introduce or postpone a new program. Japan has had an appropriate one in place for some time with adverse competitive consequences for the United States. While we have printed money to pay for imports, the Japanese have strived for export competitiveness. Quite logically, therefore, their policies are almost the opposite of ours in a number of areas detailed below:

1. Floating exchange rates have little competitive impact if fundamentals are unchanged. Large Japanese firms can absorb much of the change, especially where imported raw materials or overseas marketing costs are a large portion of the delivered price. Revaluation stimulates cost saving and modernization while reducing inflation and interest rates. Highly leveraged Japanese firms benefit directly from low cost credit. The reverse situation is true for the U.S. where rising exchange and interest rates raise both supply costs and domestic demand. Floating rates only offer a short-term adjustment, or a one-time opportunity to improve market position. New rates must be followed by appropriate changes in the fundamentals to provide any long-term assistance. At worst, floating rates act as a policy opiate which continuously but unsuccessfully tries to substitute for basic policy change.

2. U.S. pressures on Japan to grow faster or to liberalize imports have a marginal impact on U.S. competitiveness. Japan's and Germany's postwar economic history shows that exports have actually expanded faster than imports in periods of high domestic growth, reflecting greater cost competitiveness from higher investment rates and productivity improvement. In the U.S. where economic growth has generally been demand rather than supply stimulated (e.g., government expenditures, devaluations and tax cuts, rather than increased investment or productivity), growth has meant more imports as the U.S. has encountered supply constraints. America should not, however, project its economic policy views onto others. Currently Japan is pursuing its expansion plans via aggressive monetary policy and more public works (an investment approach similar to past policy). But the United States has increased its marginal propensity to import since 1965 from about 3-8 percent as a result of the Vietnam war and the Great Society programs that led to increased regulatory costs, environmental expenditures, and energy shortages. This has exacerbated and interacted with compounding inflation rate and a declining dollar.

3. A more open Japanese economy or more export-minded U.S. companies will not rectify the situation either. America must first be cost competitive across a broader range of industries. Arguably, opening Japan could help emerging or existing competitors in third countries while further rationalizing Japanese producers, making all more effective competitors vis-a-vis the United States. Nor is it clear that the problem is U.S. firms' low export consciousness. The leading 250 American exporters account for over 75 percent of U.S. exports. This averages $478 million per firm, and compares favorably with the leading 200 Japanese firms' average of $214 million. Thus, several U.S. firms are competing successfully on a global basis. In many major industries though, American firms have difficulties competing in the United States much less Japan. Greater export incentives, export consciousness, and liberalization are important and would be bene-
ficial if achieved. But they are not the crux of the competitive problem since export competitiveness depends on a competitive domestic base, and continued domestic competitiveness requires growth in productivity. Loss of global market share is more understandable given Japan’s higher savings and investment rates and a rise in Japanese wholesale prices from 1975 through 1978 of only 3 percent while U.S. prices were up 21 percent, or given a decline in Japanese export prices in Yen terms of 12 percent while U.S. dollar export prices were up 27 percent.

4. Attribution of the payments problem, U.S. inflation and U.S. loss of competitiveness to oil imports and OPEC is also somewhat misplaced. U.S. energy prices and oil imports relative to GNP and population remain well below those of Japan and Germany. These countries pay higher domestic oil and energy prices while running large payments surpluses and maintaining relatively low inflation rates.

Actually, the U.S. potentially has a comparative advantage in energy intensive industries. Competitively, Japan and Germany pay more per btu than America does. The error has been mandating increased costs for oil energy substitutes (e.g., the cost of coal and nuclear generation plants rose 400 percent per kwh between 1969 and 1977, of which 300 percent was directly due to regulation). The U.S. needs a rational energy policy and should reverse or offset regulatory constraints that have made alternative energy sources like coal and nuclear more expensive than oil and gas.

5. Finally, the current dollar support package does nothing to change basic resource allocations, while higher interest rates potentially discourage investment and without a major recession raise costs and prices. In sum, while current policy approaches could have some validity and benefit, as a comprehensive program to deal with the essentials of the competitive problem they are inadequate. Failure to change them means a continuation or worsening of the present situation. Dynamically, declining competitiveness depreciates the dollar and raises interest costs, an adverse cycle promoting further depreciation, a lower standard of living, more inflation, and a weakened world position, economically, politically, and militarily. The following is indicative of our present performance and the required direction of change:

(1) U.S. gross fixed capital formation’s share of GNP is the lowest of any major industrial country (17 percent), little more than one-half of Japan’s.

(2) Personal savings rate is also the lowest—about one-fourth Japan’s (6 percent of disposable income versus 24 percent).

(3) U.S. research and development’s share of GNP is declining while Japan’s is rising.

(4) Despite Japan’s recent “recession” due to an excess of desired savings relative to investment, Japan’s real growth rate has equalled or exceeded U.S. rates since 1973.

(5) From 1975 through 1978, U.S. wholesale prices rose 21 percent versus Japan’s 3 percent, and export prices were up 27 percent versus Japan’s decline of 12 percent.

(6) Japan’s trade surplus from 1975 through 1978 rose $19.7 billion; the United States’ was down $40.9 billion. The competitive consequences of a superior policy framework are real, direct, and obvious.
The solution to U.S. competitive weakness in world markets vis-à-vis Japan requires a reallocation of national resources and a concern with global market share. While Japan has put its funds into investment and technology, America has consumed not only a larger portion of its real GNP but some of its existing capital stock. U.S. firms have fallen badly behind in the rate of productive investment and technological improvement, and are now falling behind in absolute levels as well. Government in Japan has cooperated with industry, has promoted rationalization and international competitiveness, and has directly and indirectly cushioned the cost competitive impacts of mandated expenditures and regulations. The United States has not. If U.S. policies do not change, Japan's competitive differential will remain and compound. Lower savings and investment rates mean declining productivity, more inflation, less research, a weaker dollar, higher capital costs, increasing world economic tensions, and rising internal dissatisfactions. Continued government regulations for their own sake without appropriate political trade-offs, cost/benefit analyses or user cost offsets exacerbate this. Reduced to its simplest terms, the economy's rational and coordinated management is an economic and political necessity for survival in a competitive world.

Yet, clearly, the Keynesian and neo-classical theories that currently dominate economic thought no longer provide a good approximation of economic and competitive realities, domestically or internationally. This fact, however, does not argue for a retreat to either a classical laissez-faire approach or to a fixed monetarist position. Rather, what is needed is a balance between supply and demand management, in which regulatory, tax, fiscal, and monetary policies are concerned with their dynamic impact on both sides of the equation. The idea should be to stimulate a resource allocation that will move the supply curve and the demand curve to the right in parallel fashion. We cannot focus just on demand or supply alone.

Rapid real economic growth worldwide has created a new context. We live in a mixed economy where some government interference is inevitable and beneficial. We can ask, though, that this be intelligent and appropriate, that economic policies be effective and that theories reflect changes in the real economy. This is what we can learn from Japan.

Such a major change in political economic ideology requires government, business, and labor to work together on a national reeducation effort. Any analysis of competitive policy interaction leads to this conclusion because Japan cannot be expected to alter its logical systemic formula for economic success. As noted, the alternative is not attractive: increased world economic tensions, declining U.S. credibility, and increased internal squabbles over a smaller economic pie. America's fate therefore remains where it always has been, in its own hands. Only if we can meet this challenge to ourselves, will the world as a whole benefit and will the 1980's be other than a worsening continuation of the 1970's.