EAA Interview with Edward J. Lincoln

Edward J. Lincoln returned to Brookings as a Senior Fellow in September 1996. For the previous two-and-a-half years, he served as Special Economic Advisor to Ambassador Walter Mondale in Tokyo, Japan. In that capacity, he was responsible for providing Ambassador Mondale with analysis and advice on economic developments important to the conduct of bilateral affairs. Prior to his position in Tokyo, Dr. Lincoln had been with the Brookings Institute for nine years.

At Brookings, Lincoln specializes in the Japanese economy, U.S.-Japan economic relations, and broader Asian economic topics. His latest book, *Troubled Times: U.S.-Japan Trade Relations in the 1990s*, was published by Brookings in May 1999. His previous publications at Brookings include *Japan's New Global Role* (1993), *Japan's Unequal Trade* (1990), and *Japan: Facing Economic Maturity* (1988). In addition, Lincoln has published numerous articles and has spoken widely on issues related to Japan and U.S.-Japan relations. He also teaches a course on the Japanese economy at Johns Hopkins University's School of Advanced International Studies.

Lincoln holds a bachelor's degree from Amherst College and both a master's degree in East Asian Studies and a doctorate in Economics from Yale University. He has served on the board of directors of the Japan-America Society of Washington, D.C. as well as the advisory boards for the Japan Society of New York and the *Journal of Japanese Studies*.

In the following interview with *EAA* editor, Lucien Ellington, Lincoln discusses the reasons why Americans should learn more about Japan's economy and U.S.-Japan economic problems.

Lucien: *Ed, thanks for agreeing to be interviewed. Could you share with our readers how you became interested in your discipline, economics, and your specialization area, Japan?*

Ed: That's a good question, since very few students back in the 1960s were interested in Japan, much less the Japanese economy. My story is quite typical of others in my generation—most of us have accidental personal reasons for pursuing a Japan specialization.

After a brief two-week unit on economics my senior year in high school, I was sufficiently intrigued to pursue it in college. The introductory course excited me more, so I rather quickly decided to major in economics. To me, economics provided a way to analyze and understand the nature of the transactions that make up so much of peoples' daily lives. My interest was—and continues to be—less on the purely theoretical side and more on the policy side. Economic analysis has something to contribute to many important policy issues, both domestic and international.

Meanwhile, my girlfriend during my senior year in high school was an exchange student from Japan who had come on the AFS (American Field Service) program. She, of course, had to return to Japan at the end of that brief year. All during my college years I kept thinking about finding a way to renew our acquaintance. My choice was aided by a high draft number, which kept me out of the military and Vietnam. But finding a way to finance a trip to Japan back in those days was not as easy as now. My school frowned on junior year abroad programs (an attitude that they have thankfully reversed in more recent years); trans-Pacific airfares were relatively higher than they are now, and jobs were more difficult to find from far away.

Luckily my school, Amherst College, has had a long historical relationship with Dōshisha University in Kyōto (founded in the 1870s by Joseph Neesima, an Amherst graduate and the first Japanese to be educated in the United States). Part of the connection included an annual fellowship to spend a year teaching English at Dōshisha for a small stipend and free room and board. I landed the fellowship, reconnected with my girlfriend, and altogether had a blast in Japan (especially since my classroom duties only occupied a few hours per week). Romance re-blossomed and we were married during the year (and recently celebrated our twenty-eighth wedding anniversary).

Faced with my continuing interest in economics and a new family connection with Japan, I sought a graduate program where I could combine the two, something that was also less easy to find back then. I ended up at Yale University, where I obtained a master's degree in East Asian Studies and a Ph.D. in economics, working with Professor Hugh Patrick, one of the very few specialists in the United States on the Japanese economy.

Lucien: *These days, unlike a decade or so ago, both the U.S. media and the educated public appear not to pay much attention to the Japanese economy. Economic news in the U.S. tends to focus upon either Asia's recovery from recent problems or on*

China. Do you have any reactions to this so-called "Japan Passing" phenomenon? Do you think it is important for Americans to develop some rudimentary understanding of the Japanese economy? If so, why?

Ed: The media tends to be crisis or story driven. During the 1980s, the story was the apparent success of Japan. The economy was growing more quickly than that of the United States, some Japanese firms were gaining substantial global market shares at the expense of American firms, and for the very first time Japanese investors were buying financial assets and real estate in the United States (including a number of highly visible properties such as Rockefeller Center in New York City). In the 1990s, the story was several years of rather tense, high-profile trade disputes. This was followed by concern over a possible collapse of the banking sector, weighed down by bad debts after the speculative asset "bubble" of the 1980s collapsed. By the end of the decade, though, there was no colorful media story or crisis. The banking sector had finally moved back from the brink of wholesale collapse (at least temporarily), the economy was still relatively stagnant but not spiraling downward any longer, and trade disputes had become muted. Relative to the story of dramatic contraction and recovery in other Asian countries, Japan had become rather boring from a media standpoint. Many of the important stories in Japan (such as political maneuverings), moreover, were relatively complex and not easy to reduce to a newspaper story or television sound bite.

I find this situation rather unfortunate. Japan is still the second largest economy in the world, with roughly 17 percent of global GDP. Japan is still the largest gross and net creditor in the world; what Japanese investors choose to do with their money around the globe—including in the United States—matters greatly. Despite the recent calm in the economy, financial crisis could erupt again (since the bad debt problem in the banking sector and underfunded pension problems are only barely under control).

Meanwhile, a number of Japanese firms are still at or near the technological frontier in a number of important manufacturing sectors, providing major competition for American firms. Japan may not generate the fear or excitement that it did a decade ago, but its overall economic importance has not really diminished.

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Given the very large size of the Japanese economy, and its extensive engagement with the rest of the world through trade and finance, Americans ought to know something about both the economy itself and Japanese society more broadly. Without that knowledge, it is far more likely that Americans in business or government will make mistakes in their dealings with Japan (or discover that not dealing with Japan is a mistake). My original connection with Japan was very personal; today students should be attracted to Japan because it is enormously important.

Lucien: *Many of our readers teach either undergraduate or secondary survey-level social science or history courses. What are a few generalizations or themes about Japan's economic history or contemporary economy that you consider the most vital ones for instructors to study and teach their students?*

Ed: The first important theme is the story of Japan's transformation into an advanced industrial nation. It remains the first non-Western nation to successfully complete the transition from a preindustrial state to one of the world's most affluent nations. This century-long transformation was an awesome success, and the analysis of how it occurred remains a fascinating topic. Along the way, this topic provides ample opportunity to draw contrasts and comparisons with both Western nations and the more recently industrializing nations elsewhere in Asia.

Just as one example, the Japanese government chose a capitalist model for the economy (rather than socialism or communism), but modified in interesting ways. The government has done much more to influence markets than the U.S. government has, but this hands-on approach involved less outright government ownership of companies than has been the case in Western Europe. Even today the government continues to pursue a more active "industrial policy" than the U.S. government.

Second, the Japanese economy continues to provide a wonderful opportunity to reflect upon ourselves. Even though the image of the economy has become tarnished in the 1990s, there are still some useful lessons. For example, the Japanese made genuine contributions to manufacturing through their ability over the past three decades to reduce manufacturing costs while simultaneously improving product quality (as measured by defects or average time to product failure). How organization and management techniques contributed to that outcome continues to reverberate through American corporations today. Similar useful comparisons come from such areas as health care policy, labor markets and human resource management in the corporate sector, or public transportation policy. Whether one thinks the Japanese have come up with a better solution for social and economic policies or not, the Japanese experience helps us to reflect more seriously about our own policies and behavior.

Finally, there are also some negative lessons that should be worth exploring for both students of Asia and those more interested in the analysis of the American political economy. Much has gone wrong in the 1990s. Japan illustrates some of the problems inherent to bank-centered finance, over-concentration of bureaucratic power in a mature economy, the consequences of failing to deal with problems (such as bad debts) promptly, etc. There is plenty of opportunity to compare and contrast the

Japanese experience in dealing with its problems to the crisis response in the rest of Asia.

Lucien: *Ed, for decades, many American business people, government policy makers and members of the general public have believed that Japan does not give foreign firms a fair chance to sell goods and services in the Japanese market. Were these American beliefs about unfair Japanese trade practices historically true? Are they true today?*

Ed: This has been a rather controversial topic over the past two decades. I believe that the Japanese market has been less open to foreign firms than is the case in other industrial nations, or even in comparison to most nations in the world. The penetration of imported foreign manufactured goods has been far less than in other economies, and Japan exhibits far less of the two-way flow (exports and imports) of products within narrow industry categories (known as intra-industry trade) that has been such a hallmark of trade for other industrial nations.

Meanwhile, very low levels of direct investment by foreign firms in Japan means that local production and sales by foreign firms have not been able to offset the low level of imports. As a result, the overall penetration of foreign firms in both goods and services has been consistently well below that of other industrial nations. Over the past decade, only modest increases have taken place in the statistical indicators concerning foreign firms in Japan, and even with some improvement very wide differences remain between the penetration of Japanese markets and those in the United States or other nations.

These facts are not controversial, but there is disagreement over causation. The reason for the disagreements comes from the fact that official trade barriers—tariffs, quotas, and investment restrictions—have been low or nonexistent for the past two decades. Some economists have argued that a variety of economic factors (geographical distance from trading partners, lagged reaction of foreign firms to the lowering of market barriers in Japan, or just plain ignorance about how to do business in Japan) can explain the differences. Most analyses, including my own, suggest that something beyond these factors is involved. A variety of rather opaque problems—peculiar standards and testing procedures, collusion among firms that is implicitly tolerated or encouraged by the government, discriminatory regulations, and industrial policy—often operate in a manner to disadvantage foreign firms.

Lucien: *Given your reaction to my previous question, if you are called upon to advise a new U.S. administration on trade negotiation strategies and tactics with Japan, what basic points for consideration will you recommend?*

Ed: Problems remain, and any new administration in 2001 will need to confront them. The world has been gradually drifting toward more open markets for trade and investment. Given the large size and affluent nature of the Japanese economy, continued movement in that direction is important for American interests. Indeed, continued evidence of a disparity between market access conditions in Japan relative to other nations undermines political commitment toward open trade and investment in the United States and other nations. I would suggest a three-part approach.

First, the new administration should make a major push in getting a new multilateral round of market-opening negotiations initiated (assuming that the Clinton administration fails to overcome its failure at the Seattle WTO meeting before leaving office). Some bilateral problems could be addressed in this manner, especially by negotiating agreements that cover more service-sector industries. Dealing with Japan in this round will not be easy (especially on agricultural products), but there are good tactical and political reasons for moving some issues to this venue.

Second, in those areas where agreements already exist, but disputes arise over their enforcement, we should also use the WTO to the extent possible. The loss of the case against Japan on access to the color film market is a sober lesson in the limitations of the WTO in coping with convoluted or obscure trade barriers. Nevertheless, having strengthened the dispute resolution mechanism within the WTO, we should make maximum practical use of it.

Third, other issues should be handled on a bilateral basis; access to the large, affluent Japanese market is just too important to be ignored. We should not expect that all market access problems will ease as the Japanese confront their own economic problems, and many negotiations concerning market access in Japan just do not fit within a multilateral WTO round or even within the jurisdiction of the WTO dispute mechanism. There is no choice but to pursue these issues bilaterally. However, there is no longer any need to raise the political profile of these negotiations to the high levels that prevailed periodically in the 1980s and 1990s.

Even in a less charged atmosphere, though, the negotiating tactics will need to include occasional consideration of retaliation against the interests of Japanese firms. For all the academic outcry about the need for a better or softer way to handle negotiations, the reality is that these negotiations can be very difficult, and leverage matters. Japanese government officials attempting to deflect American pressure on market access approach their negotiating task with the same dedication and effort that the U.S. government put into arms negotiations with the Soviet Union in the past.

Lucien: *What about investment opportunities in Japan for foreign firms? Is the situation better, worse, or about the same now compared to, say, the early 1980s? Do you have any advice for U.S. government policy makers who would like to increase American business investment opportunities in Japan?*

Ed: Clearly something interesting has happened in Japan in the very recent past, and especially over the past two years. As I noted earlier, the record in the past has been one of very, very low foreign direct investment into Japan, even after all formal restrictions were lifted by the beginning of the 1980s.

Beginning in 1998, foreign direct investment into Japan has risen very sharply—with the annual inflow doubling in 1998 and 1999. This has included some notable investments, including Renault's purchase of a strong minority stake in Nissan (37 percent), Ripplewood Holdings' (an investment firm in New York) purchase of the remains of the Long Term Credit Bank of Japan, and Merrill Lynch's acquisition of the retail offices and personnel of defunct Yamaichi Securities.

Just a few years ago, such acquisitions were truly unimaginable. Selling out to foreign interests was something that Japanese firms had actively avoided and discouraged as official investment barriers were lowered. But in the past couple of years, some companies that have been hard pressed financially have accepted foreign ownership as the only viable survival strategy. The government has given this trend its tacit approval.

So what should the U.S. government do at the present time about investment? Nothing much. For the past decade there have been negotiations on the investment issue, dealing with a variety of small changes in policy (including minor changes in tax rules, more investment promotional activity by the government, etc.) that did not make much difference. The incoming administration should allow the currently more favorable investment trend to continue on its own.

If there is a role for the U.S. government, it lies in reinforcing the present environment by publicizing the value of foreign investment for Japan. Just as foreign investment in the United States has been beneficial for the economy (bringing jobs, technology, and a demonstration effect on domestic American firms), so too is foreign investment into Japan good for their economy. My one concern is that the current acceptance of foreign investment in Japan could be a short-run phenomenon. As the foreign presence becomes larger and more visible, it could well cause a backlash. Once the economy recovers and firms are no longer on the verge of bankruptcy, they could well revert to actively avoiding foreign ownership. Therefore, some gentle speeches pointing out the advantages to Japan of continuing the current receptivity might be helpful.

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Lucien: *Given Japan's lingering economic hard times and, in the eyes of many, the spectacular U.S. economic success of the last few years, does it really matter or not whether the U.S. government continues to spend substantial amounts of energy upon trade negotiations?*

Ed: Let me start by repeating the comments above. Japan is the second largest nation in the world, and often the source of major global competition for American firms. Therefore, access to Japanese markets matters. From that standpoint, it does matter whether or not the U.S. government spends time on trade negotiations.

Furthermore, the absence of vigorous trade negotiations is immediately obvious to the Japanese government. Officials there remain closely attuned to the nuances in American policy, and when the U.S. government reduces pressure, progress reducing trade barriers tends to cease. This is very much the case at the moment. Sadly, in that situation, problems fester and American frustrations mount over time, leading to a cyclical pattern in bilateral relations.

Nevertheless, there are three critical caveats that imply the U.S. government should not—and will not—spend as much energy on trade negotiations over the next several years as has been the case in the past decade.

First, the anxiety Americans felt about Japan's economic success a decade ago is gone. With Japanese firms gaining global market share and snapping up real assets in the United States, the sense of unfairness associated with the relative lack of access to Japanese markets was quite strong. That sense of unfairness, or even danger (if Japanese firms could follow "strategic" trade policy and use profits generated in a protected home market to subsidize their advance overseas at the expense of their American competitors) drove much of the high-level attention by the Reagan, Bush, and Clinton administrations.

But American firms today feel much more confident. Many feel that their technological advantage over Japanese competitors has widened somewhat in the past five or six years, and Japanese firms in a number of industries stumbled despite the presumed advantages of a protected home market. Unless or until the sense of relative competitive strength shifts again, the U.S. government will face less pressure from American business to press Japan on market access issues.

Second, the favorable investment trend has opened some new opportunities for some American firms. Unless these firms bump up against new limitations on their ability to do business in Japan, this also means that the U.S. government is not getting as much pressure from business.

Third, other international economic policy issues will rank higher than trade problems with Japan. This year, completing the process of getting China into the WTO and revoking the need for annual Congressional approval of most-favored-nation status are clearly more important, and will require substantial effort by the Clinton administration. Over the next several years, the process of starting and negotiating the next multilateral round of market-opening measures in the WTO will also take priority. This process involves Japan, but submerges the specific issues with Japan in a larger multilateral context.

None of this means that Japan will disappear as an economic policy issue. Trade negotiations will continue and will occasionally be punctuated by visible tension. But I would be surprised if the overall priority given to bilateral trade negotiations returns to the high level of the past.

Lucien: *Thanks, Ed!* ■