

2. JAPAN IN THE PRE-SUMMIT INTERNATIONAL POLITICAL ECONOMY

The defeat of Japan in World War II devastated the Japanese economy.¹⁰ Almost all of the big cities were burned. Most of the production facilities were destroyed. One third of domestic wealth was lost. Until 1951, Japan remained an occupied country with a per capita GNP less than that of Brazil or Malaysia.¹¹ Its international trade was feeble. Its vulnerability was underscored by its total dependence on imports of raw materials. To redress this inherent economic weakness, Japan had to export manufactured goods. The Japanese government improved the competitiveness of Japan's products through industrial policy, tight capital controls and protectionism. Import barriers were enacted to breed "infant industries". Export expansion was promoted through various tax and monetary incentives.

To gain access to markets for its exports, Japan depended on the United States.¹² The US made efforts to persuade reluctant European countries to open their markets to Japanese manufacturers and to provide Japan with most-favored-nation treatment. It also helped Japan join the IMF and the World Bank in August 1952. Japanese participation in the GATT, however, met stiff opposition from the Europeans. Though Japan became a Contracting Party to the GATT in 1955, other members that shared 40% of Japanese exports, led by Britain, made the GATT's nondiscrimination provisions inapplicable to Japan by invoking Article 35. It was not until February 1963 that Japan became a full-fledged member of the GATT.

The consensus over Japanese foreign policy in the Japanese government during the 1950s centred on a desire to have Japan admitted to the international society of nations as a formal member.¹³ Economic recovery led by export growth, driven in turn by huge plant and equipment investment, took precedence over other politico-strategic issues. Article 9 of the Japanese constitution (the peace clause), imposed by the Americans, outlawed the formation of large military forces. Japan could thus single-mindedly engage in policies directed at economic growth. Special US procurement requirements generated by the Korean War accelerated Japanese economic revival. Japanese exports expanded under the Bretton Woods system of fixed exchange rates, where the Japanese yen was pegged at a favourable 360 yen to the dollar.

Since Japan's import demand was greater than its exports, Japan suffered from chronic balance of payments deficits until the mid-1960s.¹⁴ The problem required tight government controls on external flows, including measures such as import quotas, high tariffs, and a close monitoring of external transactions. However, Japan's rapid industrialization, growing productivity and adoption of innovative technology made Japanese industries increasingly export-competitive. Thus, import demand was gradually overtaken by exports. With the adoption of the General Principles of Liberalization Plans of Trade and Foreign Exchange, the liberalization ratio of imports was fixed to increase from 40% to 80% within three years. It was further advanced to 90% by September 1962. In 1963, the GATT's offer of full membership for Japan facilitated the trend. Japan could no longer restrict imports on the grounds of international payments difficulties. GATT membership brought benefits to Japan, as the advent of the Kennedy Round showed. The year 1964 marked a turning point for Japan's efforts to liberalize its markets and seek its proper position in the world political economy. In April, Japan ratified Article 8 of the IMF, thereby beginning its removal of foreign exchange controls on current account transactions. In the same month, Japan was admitted to the exclusive club of industrialized nations -- the Organization for Economic

Cooperation and Development (OECD). At that time the number of "illegal" quotas was reduced to 136.

As the Japanese economy continued to grow at an unprecedented double-digit rate, and as its volume of trade increased, Japan's relations with the West deepened.¹⁵ In 1963 regular consultations between European and Japanese foreign ministers began. Japan subsequently reached trade agreements with some of the major countries for the opening of their markets. Bilateral commercial relations expanded smoothly and in a balanced manner. Exports from Europe to Japan between 1958 and 1970 rose by 609%, while those from Japan to Europe increased by 953%.

Meanwhile, Japan's trade relationship with the US began to change.¹⁶ Since 1965, Japan ran a trade surplus with the US, as the stable Bretton Woods fixed exchange system began working to the advantage of Japan. The undervalued yen rendered Japanese products competitive overseas, contributing greatly to an export-led economic expansion. Japan's exports to the US during 1964-1970 expanded at a rate of 22% annually. American complaints about trade imbalances mounted. Innumerable tariffs and non-tariff barriers (NTBs) were cited by US officials as a reason for the growing imbalance in the bilateral merchandise trade. US pressure for easier access to Japanese markets intensified. Beginning with the textile wrangle with the Nixon administration (1969-71), US-Japan economic relations became politicized. Japan responded to US pressure by phasing out import barriers and export incentives for its "infant industry". Japan also promised to cut its import quotas by half in October 1969. Similarly, additional quotas were steadily eliminated. Thus, Japan was in the process of gradually opening its markets in the early 1970s.

At the same time, Japan encountered two dramatic external events that fundamentally affected the future course of the Japanese political economy. Firstly, the summer of 1971 saw the American economy under a great deal of strain. Until the late 1960s, Americans had regarded both their political and economic interests as being served by a prompt recovery of the European and Japanese economies.¹⁷ To ensure political stability in those areas, international economic growth under the guidance of American hegemony had been deemed a necessary part of an appropriate national security policy. Consequently the US had shouldered the burden to help stabilize the international trade and monetary system. Until the late 1960's, its trade system had basically been directed at encouraging free trade all over the world, and its monetary policy was largely based on "benign neglect".¹⁸ The latter meant that the US was to minimize government interference to manage international money flows or to defend the dollar. This attitude began to change with the escalation of the Vietnam War and the budget deficits caused by Johnson's expansionary "Great Society" program.¹⁹ The result was a huge capital outflow from the US. American dollars flooded world financial markets and US inflation was transmitted to the West European countries and Japan through the monetary system. These nations were compelled to accept inflated dollars at face value under the fixed exchange rate system. The Nixon administration's stimulus to the US economy unleashed renewed inflationary forces, resulting in the further undermining of confidence in the dollar. The continued capital outflows in 1970 were followed by a steady deterioration in the US trade account in 1971.²⁰ These developments led to a loss of confidence in US economic policy.²¹ As a reserve-currency economy, the US was free to generate more international money (dollars) as long as dollar-holders retained the view that the value of the dollar would be "as good as gold".

By the summer of 1971, however, it was clear that confidence in the dollar had been

greatly shaken.²² Different inflation rates between the US and other economies led to an erosion of confidence in the dollar, which in turn caused chaos in foreign exchange markets. The Nixon administration was under pressure to convert a gigantic volume of inflated dollars into gold. Since US gold reserves were not sufficient, the international monetary system of fixed exchange rates with the dollar as the international currency threatened to collapse. Increasing speculative attacks on the dollar in mid-August, coupled with the first American trade deficit since 1893 and a disappointing report on American economic recovery, convinced the Nixon administration of the need to resort to drastic unilateral measures to prevent the outflow of gold and to shift to other economic partners the burdens of leadership in the international political economy.

Nixon's New Economic Policy (NEP) of August 15, 1971 began a transformation of the international monetary system.²³ Domestically, it imposed a 90-day wage and price controls scheme to restrain rising inflation. The external measures of a 10% import surcharge and suspension of the convertibility of dollars into gold were designed to put enormous pressure on America's trading partners to revalue their currencies against the dollar. In effect, these unilateral actions led to the breakdown of the Bretton Woods system; the realignment of the major currencies was subsequently completed by the Smithsonian Agreement in December. In order to give America more economic and political room to manoeuvre, the fixed exchange rate system was later replaced by a floating rate system. This abandonment of monetary leadership by the US caused the loss of international financial discipline, and made the international monetary and financial system increasingly unstable.²⁴ Now market forces rather than governmental negotiations would fundamentally determine the appropriate exchange rates of the major currencies, aggravating the difficulties of macroeconomic coordination. As a result, inflation became entrenched as an international problem as well as a national concern.

The August announcement by Nixon had a catalytic effect on Japan. Following "the first Nixon shock" of the Sino-American rapprochement in July, this second shock further worsened relations between Tokyo and Washington.²⁵ The US-Japanese relationship had hit its lowest point when Nixon abruptly made public his plan to visit Peking without any prior consultation with the Sato administration in Japan. This first Nixon shock shook the power base of the pro-Taipei Sato against the pro-Peking members of his Liberal Democratic Party (LDP) and contributed to his later downfall and loss of influence within the LDP. In the Nixon administration, criticism against Japan was also growing. Washington was frustrated by the on-going US-Japan textile dispute that had not been resolved, despite Sato's pledge in 1969. Arguments against the Japanese "free ride" on American military protection were raised in Washington. Japan was also being blamed for the worsening US trade deficit. In response to an American request, the Sato cabinet decided in June on an eight-point program which included reduction of tariff rates and a further elimination of remaining import quotas.

Japan had no choice but to adjust to the new international situation created by the latest Nixon shock. Immediately after Nixon's decision, the Japanese government continued to implement its proposed economic program. The pending textile dispute was resolved in October with great concessions by Japan. This sort of shock treatment brought home to Japanese government officials the necessity of maintaining accessible Japanese markets to foreign imports, lest Japan lose its market share in North America.²⁶ At the fall GATT session, the Japanese delegate urged the initiation of a new round of trade liberalization at the earliest possible date and proposed the establishment of a working group to prepare for it. But US pressure did not ease. Between August and December Treasury Secretary John Connelly pressed hard for

exchange rate realignments and a greater opening of the European and Japanese markets. Consequently, one objective of the NEP in August was fulfilled by a \$13 billion turnabout in the US trade account.²⁷

A fundamental currency realignment took place at the Smithsonian Institute in Washington in December.²⁸ The gathering devalued the US dollar 8.57% in relation to gold. The Japanese yen was revalued 16.88% -- more than any other currency -- and fixed at 308 yen to the dollar. This was a Japanese concession that went beyond domestic expectations. The yen's revaluation was partly reflected in a decrease of real economic growth in 1971. Growth dropped by 3% from 8.3% in 1970 to 5.3% in 1971. Although the US agreed to lift the 10% import surcharge in exchange for the agreement, the high-handed approach by the US instilled anti-American nationalistic feelings in many Japanese.²⁹ There were calls for a more independent foreign policy. Prime Minister Tanaka's opening to China was a response to such domestic demands.

The Nixon shocks did not, however, reorient the direction of post-war Japanese diplomacy. Japan's reliance on the US-Japanese relationship continued. Yet the August measures did bring the erosion of American economic hegemony, the demise of "Pax Americana", and an increase in Japanese international monetary responsibility. The "shock" suffered by the Japanese was attributable to a misperception of Japan's economic status in the world. The American perception of Japan as a mature economy powerful enough to revalue its currency and to restrain its export drives was not widely shared by the Japanese. Japan was concerned about protecting its newly gained capacity to balance its trade account by exporting more than importing. It feared that the Japanese economy would be greatly upset by the breakdown of the fixed rate system.³⁰ Japan's concern proved to be wrong as its overall trade surplus and its bilateral surplus with the US continued to grow.

The Smithsonian Agreement did not, however, result in a better trade performance by the US.³¹ The US trade deficit more than doubled in 1972 to \$6.3 billion. The protectionist drive in the US Congress gained momentum. The Foreign Trade Act of 1972, if it had been passed, would have put quotas on a wide range of imports and restricted American foreign direct investment to a substantial extent. Japanese economic policy concentrated on avoiding a second revaluation of the yen.³² Despite a "seven-point program" announced in May 1972, speculation that the yen would regain its former value did not die on foreign exchange markets. To neutralize pressure on the yen and to reduce Japan's multilateral trade surplus, Tokyo presented a new package directed at reducing import quotas and decontrolling international capital transactions. A 20% across-the-board tariff cut on manufactured and agricultural imports was announced, and the Ministry of International Trade and Industry (MITI) declared its intention to begin promoting an orderly growth in exports. These efforts did not bring about the desired objective. On February 12, 1973 Nixon devalued the dollar 10%, putting an end to the temporary scheme worked out at the Smithsonian. The yen subsequently moved into the flexible exchange rate system and appreciated to 263 yen to the dollar by July 1973.

The transformation of the Japanese economy initiated by "the second Nixon shock" was completed with the first oil crisis starting in October 1973. As more than 99% of Japan's oil supply came from imports, the quadrupling of oil prices hit Japan hard and shook its economic foundation to the core. The oil shock terminated Japan's economic "miracle" of double-digit GNP growth. Japanese overdependence on imported oil for its economic achievement exposed its economic vulnerability. In 1974, the economic growth rate

plunged to zero from the average rate of 9.1% during the preceding five years. The inflation rate, as measured by the Consumers Price Index (CPI) soared to 24.5%, an all-time high since 1950. The current account deficit reached \$5.7 billion.³³ The most severe post-war recession set in.³⁴

The oil shock inflicted long-lasting damage on the Japanese government.³⁵ After 1973, the government's budget deficit rose from about 3% to 7% of its GNP. The government employed a very tight fiscal policy, including contraction, postponement of public-works projects, and a rise in its official discount rate from 4.25% to 9% at the end of 1973. However, its policies did not compensate for a steep drop in government revenues. The huge deficit created by 1975 was covered by issuing 10-year bonds. More profoundly, the budget deficit resulted in the reversal of capital flow with Japan. After the oil crisis, large amounts of capital flew from the private sector to the public sector. However, the international competitiveness of Japanese industry was, after an initial bout of confusion, not severely damaged by the oil shock. Japan survived the oil shock thanks to the initiative of the private sector.³⁶ The Japanese decided to work harder and cut back on the consumption of petroleum. Rationalization of production lines, coupled with modernization of plant and equipment, greatly reduced the cost of manufactured products in many industries. A number of the more wasteful or highly energy-intensive industries were phased out. Consequently, Japan had a leaner but more efficient economic structure that produced more competitively-priced manufactured goods for world markets. Indeed, the insecurity of Japan reinforced by the oil crisis gave birth to even greater export efforts. Assisted by the depreciated yen brought by the oil shock, Japan's overall trade balance went into surplus again in 1975.

Diplomatically Japan deviated temporarily from its traditional US-centered approach to foreign issues by attempting to diversify its foreign relations.³⁷ Japan renewed its efforts to cultivate closer economic ties with the Organization of Arab Petroleum Exporting Countries (OAPEC) by sending a series of envoys and pledging a number of industrial projects. Its rapprochement policy toward the OAPEC was reinforced by US Secretary of State Henry Kissinger's refusal to fill the petroleum shortage in the case of a severance of Middle East oil supply. Japan acquiesced in the oil producers' pressure for producing a pro-Arab declaratory statement on Mid-Eastern issues. It was not until the end of December 1973 when Japan was accorded a "friendly country" status, and fear of a supply shortage dissipated, that Japan responded affirmatively to Kissinger's call for setting up an energy action group. Japan was apprehensive about this being "a cartel buster" aimed at OAPEC. At the Washington Energy Conference in mid-February 1974, Japan played a mediatory role between the US, which advocated the solidarity of oil consumers, and France, which emphasized a cooperative approach to the oil producers. In the end, the French-American deadlock was broken by a Japanese diplomatic initiative. It was agreed to establish an energy adjustment group to follow up the conference. Japanese points such as the possibility of bilateral transactions between an oil producer and a consumer, and the importance of international cooperation, were inserted into the communiqué.

Thus, Japan's desperate need for guaranteed access to oil forced it to adopt a policy that momentarily broke from its normal relations with the US. Japan reacted in an unusually self-assertive way in response to the oil crisis, when its national interests were jeopardized. However, as the situation improved, Japan soon resurrected its US-focused foreign policy. Still, relations with the major oil suppliers were strengthened. By March 1974, direct oil imports went up to 12% of Japan's overall oil imports, from a level of only 7% in the first half of 1973.³⁸ The greatest change in Japan's foreign

policy was its adoption of "resource diplomacy", aimed at searching for new energy sources and cementing its relations with traditional producers.³⁹

The oil crisis also had significant effects on the structure of the world political economy.⁴⁰ It underlined American interdependence in the international economy. Now inexpensive imported oil was recognized more than ever as essential for running American industries as well as dampening inflationary pressures and turning around the trade account. The crisis further reduced American leadership in the world political economy by producing a new bloc of power. Moreover, the oil price-hike plunged all oil-consuming industrialized nations into a severe economic slump. Disorderly and self-centered responses to the crisis by the major industrial economies exacerbated the international situation, undermining their potential bargaining position vis-à-vis the oil-producing bloc. The need for policy coordination as exemplified by the international energy conference at Washington led to the establishment of the International Energy Agency (IEA) under American leadership. In addition, the oil crisis ultimately led to the creation of policy cooperation mechanisms in the form of economic summitry.

The subsequent Japanese current account deficits, as a consequence of higher oil bills, ushered in a relatively calm era for Japan's commercial relations with its trading partners. As the Japanese trade surplus with the US declined, the pressure on opening the Japanese markets to rectify the bilateral trade imbalance dampened. In 1974, the Japanese current account deficit amounted to \$4.7 billion, although its trade position was to recover in the following year. When the invitation to the economic summit at Rambouillet reached Tokyo from Paris, Washington regarded the Japanese trade system as "reasonable and not a major problem."⁴¹ Ironically, the enormity of economic problems caused by the Nixon shock and oil shock paved the way for Japanese participation in summit diplomacy. As distinct from some of the succeeding summits, the fear of being singled out for criticism by other economic partners for its trade practices was not felt by the Japanese participants at Rambouillet.