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11 National Security Aspects of United States–Japan Economic Relations in the Pacific Asian Region

Martin Feldstein

Several years ago the National Bureau of Economic Research began a major project on the economics of national security. We wanted to look beyond the traditional issues of defense budgeting and military procurement to focus on the broad economic forces that could affect the security of the United States in future decades. One aspect of this research has been a major study of economic transformation in Eastern Europe and the Soviet Union, since economic developments there are likely to be important for the political and military stability of that region and therefore of Europe and the Middle East.[1] The second major area of our research on national security has focused on the relationship between the United States and Japan.

The present conference was designed to explore the frequently raised question, "Are United States–Japan relations in the Pacific Asian region a potential national security risk for the United States?" In a departure from our usual approach, the research team for this project was expanded to include political scientists as well as economists, and the project was co-managed by economist Jeffrey Frankel and political scientist Miles Kahler.

Three types of questions were posed to the economic researchers in the project. Is the Pacific Asian area becoming an economic "bloc" with an unusual concentration of trade, finance, and investment? Does Japan dominate the economic relations of the region, including trade flows, finance, and investment? Are the Pacific Asian countries becoming dependent on Japan for trade, finance, investment, and foreign aid?

We asked the political scientists three much more difficult questions. If an

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1. Many of the NBER studies of this subject will be published in O. Blanchard, K. Froot, and J. Sachs, eds., *The Transition in Eastern Europe*, vols. 1 and 2 (Chicago: University of Chicago Press, forthcoming).

economic bloc centered on Japan is forming in the region or will develop in the future, what effect will that have on the political alliances of the region's countries with the United States and with Japan? Similarly, what effect will it have on potential security relations in the area? And, more generally, can these developments pose a military or more general national security risk for the United States?

Although the political scientists were not able to answer the questions as we had posed them, they did teach us a number of quite different but very important things about how to think about the relation between national security and economics. The political scientists emphasized that there is more to a "bloc" than nonsymmetric patterns of trade, finance, and investment, and that it is therefore necessary to look in a more disaggregated way at specific industries and economic relations in order to understand the changing patterns of power and influence that follow changing economic relations. They reminded the economists that observed patterns of economic activity do not reflect just natural comparative advantage and geographic distance but depend on government policies and that policies in turn reflect interests within countries. And they noted that Japanese foreign policy and foreign economic policy are evolving and this evolution can be understood only by recognizing the existence of heterogeneous forces within the Japanese bureaucracy and the Liberal Democratic party. I found these comments very useful in themselves and important as a guide to future research.

My task now is to summarize what I have learned about the original subject: the national security risk to the United States implied by the evolving United States–Japan relations in the Pacific Asian region. It will be helpful if I do this in terms of five questions.

1. Is the Pacific Asian region becoming an economic bloc centered on Japan? Jeffrey Frankel's statistical analysis has shown that there is nothing about the overall trade pattern to suggest that this area is becoming a trading bloc, any more than geography alone would suggest, or that Japan is playing a particularly central role in trade within the region. Future studies at a more disaggregated level will be necessary, however, to determine whether this is also true in key industries and products.

In contrast to trade, there is no doubt that Japan has become the dominant source of foreign direct investment in the region, far outstripping the level of investment from the United States and Europe. The political scientists have persuasively urged that the next step should be an analysis of patterns of ownership and control that determine the extent of influence and dependence. A similar predominance of Japan has also developed in the flow of development assistance in the region.

The pattern of financial flows is more unclear, but the trends suggest a growing role for Japan and the yen in the financial relations of the region. Whether the recent weakness of the Japanese banks will change this remains to be seen.

2. Is Japan acting in ways that could lead to a hegemonic position in the Pacific Asian region? There is a range of voices in Japan calling for a more inward-looking policy for Pacific Asia with a dominant role for Japan. In the extreme, this is summarized with the slogan, "Asia for the Asians." The advocates of such a policy point to similarities of East Asian culture in the broadest sense (e.g., the Asian emphasis on consensual politics), of religion (i.e., the importance of Confucianism and Buddhism and the minor role placed by Christianity), and of race.

At a more practical level, businessmen and government officials in Japan point to the development of EC92 in Europe and the North American Free Trade Agreement and argue that Japan (or Asia) needs to protect itself with a similar Asian economic bloc. Some Japanese are talking about the desirability of developing an East Asia coprosperity sphere, despite the very negative historic connotations of that term.

Some of the actions of the Japanese government and of private Japanese businesses are consistent with trying to establish a hegemonic position in the region. The most obvious of these is the dominant role of Japanese direct investment in countries like Thailand and Indonesia, where Japan's activity far outstrips that of the United States and Europe.

There is also no doubt that Japanese official development assistance is generally targeted for Asian countries, with much of it going to rapidly growing countries rather than to those countries with the greatest poverty. Although there is evidence that most of the aid is not literally tied with "buy Japan" requirements, critics complain that the aid is given in a form that is advantageous to Japanese business interests (like the financing of transportation and other infrastructure that would be useful for international trade).

Such criticism seems excessive. Even if Japanese development assistance is helpful to Japanese business, that is not inconsistent with its helping the recipients as well and even with its benefiting businesses in the United States and other trading partners as much as it helps Japanese businesses. Moreover, Japan is not unusual in restricting its aid in various ways.

A third way in which Japan may be strengthening its role in the region is by dealing more actively than the United States with China and Vietnam. But here the explanation is that U.S. domestic politics impedes American activity rather than that Japanese policies in the area have been particularly aggressive.

In short, there is some behavior that may increase Japan's relative strength in the region, but it would be difficult to interpret this as evidence that Japan is seeking to establish itself as a hegemonic power in East Asia.

3. Does Japan want to establish a hegemonic position in the future? Although current behavior cannot be interpreted as an active pursuit of hegemonic status, it is interesting to ask whether the Japanese want to establish such a position and will take steps to do so in the future.

There is not doubt that there are potential economic rewards of being the local hegemon. By excluding others from the market or restricting their access, a Japanese hegemon could enjoy the benefits of being a monopoly supplier or a monopsony purchaser. More subtle advantages could accrue to firms that use exclusive access to develop more advantageous integrated production arrangements.

Another reason Japan might want to develop a hegemonic status in the region is to promulgate its development strategy. Many Japanese officials and academics have recently contrasted the Japanese approach to economic development with the approach advocated by the United States, the World Bank, and other "Western" authorities. The Japanese emphasize a greater role for government at the early stage of development, a different approach to domestic competition, different intercorporate financial arrangements, and so forth. The desire to promote the Japanese approach to development may reflect honest differences of development philosophy. It may also (or alternatively) reflect a desire to have neighboring countries pursue development strategies that are more compatible with current Japanese industrial policy and with the mode of operation of Japanese private industry.

Finally, the Japanese may want to establish a hegemonic role in the region as a matter of national pride. At a time when the major industrial countries are calling on Japan to exercise more "leadership" in world affairs, it is easy to confuse hegemony with leadership.

But even if there are many in Japan who would like to see a Japanese hegemony in the Pacific Asian region, I believe it is unlikely to occur. The desire to play such a role and the benefits of establishing a hegemonic position are simply not great enough to outweigh the costs of doing so.

The greatest such cost would be the conflict that would result with the United States. The United States is not only the largest market for Japan's exports but also Japan's strongest ally in global affairs. A new generation of political leaders in Japan could be willing to pay this cost, but there is no indication of such an inclination at the present time.

A second cost of achieving hegemony would be the resistance from the individual countries of East Asia. The history of Japan as an aggressive power in the region, not only in World War II but ever since the opening of Japan in the mid-nineteenth century, makes these countries nervous about seeing Japan increase its power in the region. These countries will therefore seek to keep the United States and other nations involved in order to prevent the development of Japanese monopoly and monopsony power.

4. Will the collapse of the Soviet Union change United States–Japan relations in ways that affect U.S. national security? In many ways this is the most speculative of the five questions, particularly because of the recentness of developments in the former Soviet Union. Moreover, although there is much talk about the end of the Cold War and the elimination of the Soviet threat, substantial military risks to both the United States and Japan remain. Russia still has thousands of nuclear warheads on missiles that are potentially targeted at the United States and Japan. Moreover, the Japanese are acutely aware that they still have no treaty with Russia and that Russian soldiers still occupy the four northern islands that belonged to Japan before World War II and that Japan regards as Japanese territory.

But, to the extent that Russia (and the other parts of the former Soviet Union) is no longer a security threat to Japan and the United States, the United States–Japan bilateral relation is weakened in five distinct ways.

First, the elimination of the Soviet Union as a military threat to Japan means that Japan no longer needs the protection of the U.S. nuclear umbrella. The reduced dependence of Japan on the United States gives Japan greater freedom to develop its own policies, including polices that create conflicts with the United States.

Second, from the American point of view, there is no longer as great a need to use Japan as a base for American military presence in the Pacific area. Military considerations are therefore no longer as much of a check on potential trade conflict or other conflicts between the United States and Japan.

Third, the collapse of communism highlights the varieties of capitalism. As long as the world was divided into capitalist and communist camps, the United States and Japan were clearly members of the same club. Now the contrast between U.S. capitalism of independent shareholder-owned firms and Japanese *keiretsu* capitalism appears more sharply. This is a source of conflict not only in United States–Japan trade relations but also in the shaping of development assistance.

Fourth, the absence of a Soviet military threat makes it easier for Japan to normalize relations with China. Many in Japan look to China as the source of markets and indirectly of manpower for Japan in the twenty-first century. Although Japan's pursuit of close relations with China requires overcoming the memories of Japan's role there before and during World War II, the Japanese are making major efforts in this direction. These developments could reverse the relative importance of the United States and Japan in China. Given China's geographic size and its overwhelming population, any potential shift in China's link from the United States to Japan could have substantial long-term security ramifications for the United States.

Finally, the decline of Soviet power in the Middle East provides an opportunity for Japan to develop a Middle East policy that serves its own interests without worrying about the implications for the U.S.–Soviet conflict. Japan clearly has strong interests in the region because of its dependence on oil imports from the area. There is no reason to expect that Japan's interests in this complex part of the world coincide with the interests of the United Sates. A current example of this may be Japan's active cultivation of ties with Iran through official as well as business channels.

In each of these five ways, the collapse of the Soviet Union has changed the likely future relations between the United States and Japan. Each is now militarily less dependent on the other and therefore more likely to pursue policies that have adverse effects on the other country.

5. Is the United States vulnerable to a shift in United States–Japan relations? Despite the trade conflict, the United States and Japan have been strong allies that share a common philosophy. It is possible, however, that a combination of developments—shifting economics relations in East Asia, pressure inside Japan for that country to play a hegemonic role in the area, and the end of the Soviet military threat—could cause a significant change in the relations between the Untied States and Japan. Even if that is unlikely, it is worth asking whether such a shift could create a serious national security risk for the United Sates. Put succinctly, is the United States potentially vulnerable to a shift of Japanese policy toward the United States?

There is no doubt about the converse; Japan is vulnerable to a shift in U.S. policy toward Japan. Japan must import its food and energy. The large amount of foreign direct investment that Japan has in the United States is a hostage that is not matched by comparable U.S. investment in Japan. An antagonistic U.S. government could change tax rules in a way that drastically reduces the economic value of those investments to their Japanese owners. The hundreds of billions of dollars of portfolio investments that Japanese companies have in U.S. securities are a further hostage that could be effectively destroyed by a change in U.S. tax policy. Closing the U.S. market to the nearly $100 billion a year that the U.S. imports from Japan would do substantial damage to Japanese industry.

The Japanese are very much aware of this vulnerability to the United States. Their awareness of this vulnerability is likely to be a positive force that keeps our bilateral relationship from degenerating.

The United States does not share the same types of vulnerability vis-à-vis Japan. Our investments in Japan are very much less than Japanese investments in the United States. Our exports to Japan are also very much less, and agricultural products are a large part of those exports; a decision by Japan to reduce agricultural imports from the United States in favor of other producers would not change the global demand for U.S. agricultural products.

Many Americans worry about the "financial vulnerability" of the United States to Japan. They are concerned that the Japanese government might cause Japanese financial investors to stop the annual flow of funds to the United States or, in the extreme, might cause those investors to sell their bonds and other financial investments in the United States "and bring that capital back to Japan."

Neither of these should be a real source of concern. Because of the sharply reduced U.S. trade deficit, the United States no longer needs a substantial inflow of capital each year; the current account deficit for 1992 was only 1 percent of our GDP. In any case, if Japanese institutions stopped buying U.S. securities and redirected their annual capital outflow to investments in other countries, the funds that they displaced would flow to the United States. The most harm that would result from an unwillingness of the Japanese to make financial investments in the United States might be a very small increase in the interest rate on U.S. bonds.

The idea that Japan could "sell their bonds and bring the funds home" is based on a misconception. Even if Japanese investors wanted to sell all of their U.S. bonds (thereby precipitating a capital loss for themselves), they could not "bring the funds home" unless Japan shifted from having a large trade surplus to a large trade deficit; that is, a capital flow into Japan is only possible if Japan has a large trade deficit. A decision by Japanese investors to sell dollar bonds and shift the funds to other countries would put downward pressure on the U.S. dollar (relative to the yen and to the currencies in which the Japanese invested) and upward pressure on our interest rates relative to other interest rates in the world financial markets. The combination of a depressed dollar and higher U.S. interest rates would induce the funds displaced elsewhere by the shift of Japanese investments to flow to the United States. When the dust settled, there would be little change in the value of either the dollar or the level of U.S. interest rates. To the extent that the dollar remained lower than it had been before, the effect would be to stimulate U.S. exports (and to reduce our imports).

But although the United States is not financially vulnerable to Japan, technological vulnerability may be a real problem with potential consequences for U.S. military security. The United States now depends on Japan for semiconductors, machine tools, and many of the components of aircraft and military equipment. How vulnerable does this makes us? If Japan decided to ban the sale of such items to the United States, how long would it be before American firms could make these things? Is the number of such products increasing? Is the time that it would take the United States the substitute for such products becoming greater? I cannot answer these questions, but I believe that it is important to have answers and to keep those answers up to date.

Although the possibility of such a rupture of United States–Japan relations may seem remote, it may not be, particularly if there is a change of political power in Japan. Except for a very short period, the government of Japan has been controlled by the Liberal Democratic party. The opposition Socialist party has very different views from the LDP about military activities in general and about United States–Japan military relations in particular. It is certainly not inconceivable that the LDP could at some time during the next few years lose control of the Diet and have to form a coalition with the Socialist party or allow the Socialist party to form the government. Japan already has a policy that bans exports of weapons. This is currently interpreted in a way that allows Japan to sell critical components of military equipment to the United States. We should not assume that this interpretation would always be sustained, especially if the Socialist party were to come to power or even to be a part of the government coalition. A ban on military exports to the United States could even occur during a period of attempted U.S. military activity like the recent Gulf War, because of a general antiwar sentiment in Japan or because of a sense that the current specific U.S. policy is contrary to Japan's interests.

The United States needs to recognize this risk and consider what actions should be taken now to deal with this technological vulnerability. There are, I believe, four possibilities.

First, the United States could simply accept the new military vulnerability to Japan, recognizing that Japan is at least as vulnerable to the United States. While it would therefore be irrational for Japan to exercise its strength, the risk would remain. The existence of that risk would limit our ability to contemplate independent military actions of the sort that we did in Iraq and, more generally, would limit our ability to assure our own self-protection and our ability to use force to maintain global stability.

Second, the United States could seek to eliminate the technological vulnerability by producing the needed military components instead of importing them from Japan. Because we would not have the economies of scale associated with production for civilian as well as military use, this form of procurement could be much more expensive than importing. The costs look even more formidable if we consider the need to do the product design research and to develop the manufacturing equipment that would be needed to make the military equipment. For example, how much of a "nonmarket" machine tool industry would we need to support in order to have the capability to manufacture products that we now import, and how expensive would it be to maintain such an industry?

Third, the United States could use trade barriers to protect those industries that make products that are important for military purposes. This includes not only the final military components but also such industries as semiconductors, computers, numerically controlled machine tools, critical materials, and so forth. The United States already does this to a limited extent, most recently by protecting the U.S. machine tool industry on the basis of its military importance. In principle, the products that would be protected would be chosen on the basis of their military importance only and not as a matter of domestic industrial policy. In practice, however, it would be difficult to decide where lines should be drawn, especially since protecting products like machine tools would artificially raise the cost of making various consumer products. Should the producers of those nonmilitary products be penalized by the military decision to protect machine tools or should they be "compensated" by the protection of their products?

Finally, the United States could seek to achieve greater access to Japanese technology of military significance through joint production or other arrangements that eliminate U.S. vulnerability. Taken by itself, there is no reason for Japanese firms to voluntarily allow U.S. firms to share their technology and to produce many of the relevant products under license in the United States. The government of Japan might, however, have a different view about this if they perceived that the alternative response of the U.S. government to our current technological vulnerability might be broad protectionist legislation of the type described in the previous paragraph. The Japanese government would also recognize that, even if such protectionist legislation was not passed and the United States accepted a relation of mutual vulnerability, that could lead under the type of scenario described above to a very costly rupture of United States–Japan relations if some future Japanese government blocked the exports of Japanese products of military significance. In comparison to these alternatives, cooperative sharing of technology might seem attractive.

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