Introduction

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A common historical reading of the 1930s and World War II has long colored evaluations of regional monetary and trading blocs. Economists have typically appraised the global welfare implications of blocs negatively in comparison to a global, multilateral economic order. Political scientists have associated a regionalized international order with heightened economic and even military conflict, although some have accepted the possibility of a benign regionalism. Policymakers, influenced by these views, have hedged regional experiments with rules meant to reduce their discriminatory impact on nonmembers, most notably Article 24 of the General Agreement on Tariffs and Trade (GATT), governing preferential trading arrangements.

Until recently, with the important exception of the European Economic Community (formed in 1957), experiments in regionalism were more common among the developing countries, and even there, more likely to fail than not.[1] Even the European Community seemed limited to a customs union (with a liberalized external tariff) and several joint policies, of which only agriculture had serious implications for the global trading system. The European Monetary System (founded in 1979) initially seemed to augur little more than its expressed aim of forming a zone of monetary stability in Europe, a goal viewed with skepticism by many outsiders despite the eventual success of the EMS.

With the adoption of the Single European Act in 1985 and the subsequent

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1. A recent study by the International Monetary Fund notes that "significant difficulties have generally been encountered in implementing trade and other integration measures on schedule" in the case of regional schemes involving developing countries (de la Torre and Kelly, 1992, 32).

movement toward economic, monetary, and political union in Europe in the 1990s, the terms of debate shifted drastically. The United States and Canada have signed a free trade agreement and have entered into negotiations with Mexico to extend that agreement to a North American Free Trade Agreement (NAFTA). Only Pacific Asia has not actively engaged in a regional project, and many have asked whether the economic prerequisites for a regional bloc, centered on Japan and similar to those in North America and Europe, are not already in place in East and Southeast Asia.

If evidence for such a bloc-in-formation could be marshaled, the implications for the future of the global trading and monetary systems could be profound. Encompassing the most dynamic trading economies in the international economy and the world's largest creditor nation, East and Southeast Asia have represented a major influence in favor of strengthening the multilateral trade and monetary systems.[2] Their retreat into a regional project would knock away a major support for the global rules governing trade and monetary relations. In addition, the emergence of an East Asian bloc, however defined, could supply another item for the agenda of bilateral conflict between the United States and Japan.

The economists and political scientists contributing to this volume, then, are concerned with the ways in which the United States and Japan contribute to and are potentially affected by regionalism in East Asia. This is not, however, another work about United States–Japan bilateral economic relations or a consideration of the emerging tripolar global order. One could view each of these papers as dealing with Japan's use of its newfound economic power in one part of the post–Cold War world—East and Southeast Asia.

In part I the case for an emerging East Asian trading and financial bloc is scrutinized and tested. Part II deals with other elements in a possible Japan-centered bloc—particularly foreign direct investment—and the ways in which they might be expected to heighten the competitiveness of Japanese firms and increase Japanese influence in the region. The incentives and obstacles to Japanese leadership in Pacific Asia are described in part III.

A Bloc for the 1990s? Japan's Trade, Finance, and Direct Investment in Pacific Asia

Any Japan-centered economic bloc taking shape in Pacific Asia is not based on explicit, region-specific political arrangements. Such regional institutions have historically been weak or absent, whether the region is defined to include East and Southeast Asia only, extended to incorporate Australia, New Zealand, and the South Pacific, or equated with the Pacific Rim (including North and

2. In 1991, a year in which the volume of world trade grew at a sluggish 3 percent (its slowest rate since 1983), "the six leading non-OECD traders [in Asia] reported growth rates of 10 to 20 per cent for exports and 8 to 30 per cent for imports" (GATT Press Communiqué, 12 March 1992).

South America). The reasons for such weakness and the absence of "hard," politically determined regionalism include a preference on the part of the United States for bilateral relationships with its major allies in Asia and the radical asymmetry (at least during the early years of the Cold War) between the economic and military capabilities of the United States on the one hand, and Japan and the other noncommunist Asian states on the other. Large quantities of ink have been spilled on proposals for regional integration, but only the Association of Southeast Asian Nations (ASEAN) has emerged as a persistent (and largely political) regional entity.

As Stephen Haggard argues in his comment on Peter Petri's paper, however, such a "hard," politically driven route to regionalism is not the only route possible. Peter Petri elaborates a path to regional political institutions through a functional response to growing economic interdependence among Pacific Asian economies: politics follows economics, serving to manage the interdependence that is independently or "naturally" created by the actions of private agents. Petri, Jeffrey Frankel and Gary Saxonhouse scrutinize the evidence for growing "soft" regionalism of this variety, particularly regionalization centered on Japan. The *level* of trade interdependence within the region has been high during the postwar period, higher than one might expect from features such as geographical proximity. Both Petri and Frankel agree, however, that the *trend* in regional trade interdependence does not demonstrate a clear intensification of any intraregional bias during the post-1945 period. Indeed, Petri situates the post-1945 low point in regional trade interdependence in the mid-1980s. All three authors fail to find any pattern of Japan as a metropole in the regional pattern of trade; Frankel in particular suggests that the overseas Chinese (concentrated in entrepôts such as Hong Kong and Singapore) are more likely to provide an explanation for the high levels of intraregional trade.

Given Japan's growing global financial role, one might expect to find a stronger "Tokyo effect" through the financial markets. Any international effects on national financial markets in the region, however, are muted by the late, and still partial, liberalization of financial flows. Although Japan's influence over interest rates has grown, it rivals that of the United States in only a few regional markets. The yen's use as a peg for exchange rates in the region, in central bank reserves, and in invoicing trade and finance has also grown somewhat, but its role is far from dominant even after the expansion of Japan's financial presence in the 1980s.

To regard even these trends in the region as purely economic would be mistaken. As Petri points out, one explanation for the historical level of regional trade interdependence in the region is investment in the infrastructure of particular trade links, investment decisions that may be influenced by political or strategic calculations as well as economic ones. Larger international political changes also affect these patterns. The dismantling of the Japanese colonial empire ended one variant of "hard" regionalism that had forceably induced a high degree of regional trade interdependence. The decolonization of Southeast Asia after 1945 and the Cold War encouraged an extraregional trade strategy based on the U.S. market, as colonial entrepôts such as Singapore saw their role decline temporarily, and Japan was cut off from its traditional markets in China.

If current trends in trade and finance fail to demonstrate a clear intensification of flows within the Pacific Asia region, and institutionalization at the political level has lagged behind other regions, it may be that our image of a bloc depends too heavily on past models of "hard" regionalism based on politically determined discriminatory arrangements. It is in the area of foreign direct investment in the region by Japan and the use of foreign aid that some have identified the emergence of a "1990s model" bloc, different in external appearance from the European Community or NAFTA but closely integrated and centered on the Japanese economy.

The economic basis for such arguments lies in the changing composition of foreign direct investment in the region since the mid-1980s. All of the significant activities of foreign investors are not adequately captured by the most readily available data—those of flows of foreign direct investment. Both investment financed within the country (or in offshore financial markets) and other overseas activities on the part of firms may have important economic effects (such as cooperative arrangements with foreign firms and cooperation in production; see Doner, chap. 5 in this volume). Despite these shortcomings, it is worth noting a shift in the pattern of Japanese overseas investment flows associated with rapid appreciation of the yen that took place in the late 1980s. The absolute value of Japanese foreign direct investment increased dramatically, and even though the share directed to the Asian developing countries declined somewhat, the absolute amount of investment going to the Asian newly industrializing countries (NICs) and the rapidly industrializing ASEAN countries increased sharply. Equally important, Japan's significance to these countries as an investor (compared to the United States and the European Community) grew, and, among developing areas, the importance of developing Asia as a field for Japanese investment became clearer (Doner, chap. 5 in this volume; Petri, chap. 1 in this volume; Omori and Takata 1992, 146–47).

The search for cost advantages in East and Southeast Asia following *endaka* (strong yen) is clear in the pattern as well as the direction of Japanese foreign direct investment during these years. Unlike earlier emphasis on import substituting investments in the region (encouraged by local policies), this wave of Japanese investment, concentrated in manufacturing, served to develop a dynamic division of labor in the region. It reinforced the popular "flying geese" model of regional development in which Japanese manufacturers gradually reduce the production of labor-intensive manufactures and transfer those parts of the manufacturing process abroad. In this regard, Japanese manufacturers in East and Southeast Asia were simply following the established model of the global factory already apparent in Western Europe and the United States. As a result, Japanese investment in the region was more export-oriented than it had been previously, including a high share of intrafirm trade and an increase in exports to the Japanese market (Doner, chap. 5 in this volume; Petri, chap. 1 in this volume).[3]

Evaluating the effects of this influx on host country economic performance is controversial and difficult. Petri notes that the trade balance effects of the new investments have to date not been as positive as might have been predicted, despite their greater export orientation, because they continue to require a high level of imported components from abroad. Richard Doner notes that even the overall effect of the foreign investment surge on the level of Thailand's exports is disputed, with one study estimating that it accounts for only 10 percent of export growth in manufactures (Petri 1992, 24–25). Whatever its effects on levels of economic growth and export expansion, however, Japanese investment in manufacturing in Pacific Asia after 1985 has intensified regional economic integration in new ways.

More important than Japanese direct investment for the two most populous Asian countries—China and Indonesia—are Japanese flows of aid. Even for rapidly industrializing Thailand, which has recently been a magnet for Japanese investment, aid flows from 1989–91 totaled 35 percent of investment. The bilateral aid dominance of Japan in Asia is far more pronounced than is Japan's presence in foreign investment: the United States and Europe are hardly players in bilateral aid flows in East and Southeast Asia (Islam, chap. 8 in this volume). The integrating function of aid, however, may rest in its characteristics rather than its volume. Observers of Japanese aid policy agree that it is concentrated more in economic infrastructure than is the aid of most of the industrialized countries (Islam, chap. 8 in this volume). Considerable attention has been directed to explicit attempts on the part of the Japanese government to link the aid program to infrastructural improvements that would benefit Japanese investors, most notably in the New Aid Plan announced by MITI in 1987. Critical observers saw an effort to replicate Japanese industrial policy on a grand scale. Others, including some of the authors in this volume (Islam, Katzenstein and Rouse, and Doner), see a new label for an old pattern of aid, a grandiose program designed to expand the bureaucratic influence of MITI in the foreign aid process that is contested by its bureaucratic foes, one that is unlikely to be implemented according to the designs of ministries in Tokyo.

The investment-aid nexus has produced a weak set of institutions on the bilateral and national levels and none at the regional level, although the proposal of Malaysian prime minister Mahathir for an East Asian Economic Group or Caucus might be seen as a functional response to the new Japanese production network in Southeast Asia. If a new investment-based regionalization can be identified, it may be grounded more on diverse institutions that encourage collaboration between governments and business, institutions that

3. For a model of the effects of foreign direct investment on an ASEAN economy, see Petri (1992).

are quasi-public at best. Such institutions are being established between Japan and both public and private actors in Pacific Asia. Doner notes several institutional innovations that can be traced to the new pattern of investment and aid, such as imitation of Japanese patterns of industrial policy and public-private collaboration and the development of subcontracting networks similar to those in Japanese manufacturing. Japan has sponsored nothing as ambitious as the Singapore-backed growth triangle that aims to link infrastructural improvement and Singaporean capital with Malaysian and Indonesian land and labor.[4]

Does the new pattern of investment and aid in Pacific Asia augur a new-model "bloc" centered on Japan? Clearly, economic regionalism of this kind, weakly institutionalized, would be based on a particular form of economic integration, encouraged but not directed by government policy, producing in turn weak bilateral and international institutions. Hints of this sort of a "bloc" can be teased out of some of the contributions in this volume, but this type of grouping, even if it were to emerge, would bear little resemblance to the tightly organized and politically circumscribed blocs of the 1930s or even to the contemporary European Community. It would be a "bloc" for the era of fiber optics and informatics rather than for the age of coal, steel, and agriculture. Should it take shape, it would be aid- and investment-driven, not trade-driven (although presumably investment would influence regional trade patterns). It would be sectoral rather than territorial in scope: integration of the electronics or automobile industries throughout the region rather than all of the economic activities in Pacific Asia. Japanese government involvement would be oblique, supporting informal institutions that would offer information and infrastructure to Japanese investors, reducing the risks for private investment (Doner, chap. 5 in this volume). Finally, the channels of Japanese influence would include the influence that key investors in important industrial sectors are likely to have on host governments, host government calculations of anticipated Japanese reactions to their policy initiatives, and above all, differential access to information.[5]

The authors offer no conclusive evidence that such a 1990s-model bloc is taking shape in Pacific Asia. Indeed, to use the term *bloc* precisely, a demonstration of discrimination against European or American investors and exporters must be demonstrated. One could imagine that some of the "neural networks"[6] taking shape in the region might have such discriminatory implications, particularly the subcontracting webs described by Doner. Nevertheless,

4. On the current status of this plan, see Lee (1991).

5. As Albert O. Hirschman (1980, 16–17) noted in his classic study of international influence and economic transactions, "For the political or power implications of trade to exist and to make themselves felt, it is not essential that the state should exercise positive action, i.e., organize and direct trade centrally; the negative right of veto on trade with which *every* sovereign state is invested is quite sufficient."

6. This phrase was coined at the Del Mar conference by Gregory Noble.

many of the activities of the Japanese government in the region, particularly in the provision of infrastructure, are public goods from which other investors and exporters cannot be excluded (Katzenstein and Rouse, chap. 6 in this volume; Islam, chap. 8 in this volume). Without discrimination, the assertions of a bloc-in-formation lose much of their meaning.

The authors in this volume offer several powerful reasons to doubt that even a regional grouping of this "softer" variety will emerge. The public goods character of many of the instruments at Japanese disposal has already been mentioned. The leveling off and decline of Japanese foreign direct investment after 1990 suggests that at least part of the post-1985 surge in investment was a portfolio adjustment. The level of Japanese manufacturing investment in Southeast Asia appears likely to remain stable, however, within the constraints of infrastructural bottlenecks (Petri, chap. 1 in this volume; Omori and Takata 1992, 142, 146). The apparently unstoppable outflow of Japanese capital after 1985 may have been misread as a permanent feature in the life of the region.

More important, Japan is not the only actor whose investment is weaving together a regional pattern of production and trade. The East Asian NICs have recently rivaled and even surpassed Japan as investors in some of the countries of Southeast Asia. By 1991, for example, the cumulative investment position of the four Asian NICs in Indonesia had begun to approach that of Japan; it was the substantial investment of the NICs in the late 1980s and 1990s that spurred the export of manufactures from Indonesia (Kuntjoro-Jakti 1992). Taiwan was among the top three foreign investors in Malaysia; it also occupied a very strong position in Thailand. The immediate stimulus to overseas investment in these cases was the same real exchange rate appreciation and cost considerations that had spurred Japanese investment. Although the evidence is anecdotal at this point, investment from the NICs does not seem related primarily to Japanese investment networks or global production strategies: these are in large measure new investment entrants in the regional economy. Their rapid emergence does not suggest a sphere of unchallenged Japanese investment predominance.

The prominence of NIC investment in recent years suggests further diversification of the sources of foreign investment. The national governments of the region have demonstrated that they have both the instruments and the will to push diversification despite the perceived benefits of Japanese investment and aid. Peter Katzenstein and Martin Rouse document the efforts of Thailand to award infrastructure contracts to non-Japanese firms. Understandably, the ASEAN governments have no desire to award Japanese investors or the Japanese government the bargaining leverage of a monopolist.

A final barrier to a regional arrangement that might be both more formal and more discriminatory is the continuing dependence of both Japan and the Pacific Asian economies on the American market. The threat of American displeasure and even sanctions in the face of movement toward an institutionalization of the Japanese aid-investment network in the region is likely to prove an imposing obstacle, as it did for the modest proposal of Dr. Mahathir.[7]

Regionalism and International Conflict

Although concern over conflict between Japan and the United States has centered on bilateral trade conflict and its possible spillovers into political and security collaboration, any move toward Japan-centered regionalism also threatens conflict with the United States. Fifty years ago, worsening conflict between the two countries was owed to Japan's expansionist policies in East and Southeast Asia. No one is predicting a reappearance of conflict of that intensity, but an array of models suggests that movement toward regional blocs could intensify international conflict between the United States and Japan.

One familiar argument holds that declining power differentials between a dominant power and its rivals produce heightened conflict. Some political scientists have elaborated this view in the vocabulary of hegemonic cycles; others have proposed a more general power-transition theory of conflict. Such models suggest that a Japan-centered region in Asia would add to the anxieties of a United States already concerned over Japan's rapid economic rise: "Other things being equal, the greater (and more rapid) the relative economic decline of the United States vis-à-vis Japan (*and* Germany), the more difficult will be the problem of global security adjustment, as well as global economic adjustment" (Destler 1991). As Destler argues, the probability of Japan's becoming the single dominant power is small, but its regional dominance must be assigned a higher likelihood. For Pacific Asia to be seen as a power resource for an ascendant Japan, however, the organization of the region would need to acquire the character of a "hard" regionalism, politically determined, with much greater institutional development and economic concentration than currently exists.

Quite apart from the addition of economic dependents to a rival's power resources, it was long a matter of received faith in American policymaking that a regionalized world economy would not only lower world economic welfare but also produce heightened political and military conflict. That influential reading of the history of the 1930s shaped American attitudes toward postwar institutions—biasing the United States toward multilateralism and globalism—but it is not clear that a world organized in regional blocs would necessarily succumb to such conflict (unless the blocs were led by predatory powers such as Nazi Germany or prewar Japan). In any case, none of the contributors to this volume suggest that we are moving independently to a Pacific Asia organized on these lines. Only if the United States and the European Community adopted hard regionalist organizations or if United States–Japan bilateral

7. The continued importance of the American market as a barrier to further regional economic integration is emphasized by Yung Chul Park and Won-Am Park (1991).

conflict worsened do some argue that an East Asian regional bloc might emerge.[8]

Even a weak form of regionalism—the aid and investment network described above—could spur United States–Japan conflict. Any perceived discrimination against American firms would be read as the export of Japanese business practices (such as the *keiretsu*) that have attracted American attention and hostility in Japan itself. Such conflict could, as noted earlier, feed back into the political dynamics of Japan and other Pacific Asian countries to create the impetus for the regionalization that the United States sought to avoid. Much of this conflict would derive as much from American *perceptions* of the emerging Pacific Asian system as from the reality of discrimination or closure.

A final source of conflict, ironically, is the mirror image of concerns over an ascendant Japan: the belief that Japan does not contribute enough to the provision of international public goods, that it has been a free rider internationally and shows no signs of becoming a leader. If in the first instance, Japan is viewed as threatening because it might overtake the United States, in this case it is condemned for failing to assume some of the burdens of leadership in Pacific Asia.

Does the Public Goods Paradigm Fit the Issues of United States–Japan Cooperation in Pacific Asia?

How can we give substance to the ideas of leadership and responsibility? It is to be hoped that Japan is beginning to exercise more leadership and that the United States will not feel threatened by an expanded role for Japan. Both adjustments require a kind of maturity often lacking. The theory of international public goods at first seems the most powerful analytical tool for thinking about the issues that surround the respective roles of the United States and Japan in the region. The provision of a public good inevitably involves politics and institutions; by definition, the international private market cannot provide public goods unaided. The theory states that the optimal cooperative solution is for two countries to share the burden of helping to promote common goals in the region. In the broadest sense, these common goals include promoting peace, democracy, and stable, market-oriented economic development.

Table 1 illustrates the game for the case in which the public good is spending on defense. It could as easily be spending on foreign aid. The noncooperative (or Nash) solution is a choice by both countries to save resources by choosing low levels of defense spending. The cooperative solution appears in the last cell, where both countries choose high defense spending. Americans have accused the Japanese of free riding; this would imply a movement to the upper-right cell, where Japan leaves the United States to carry the spending burden

8. Notably, Ito, chap. 9 in this volume.

Table 1 When Spending on Defense Is a Public Good

	United States cuts spending	United States increases spending
Japan cuts spending	Underprovision of public good	Japan a free rider
Japan increases spending	United States a free rider	Cooperative solution

alone. What better analytical tool to apply to this problem than the Nash bargaining game—in its simplest form, the prisoner's dilemma—a tool that is shared by economists and political scientists?

Many policy issues examined by the papers in this volume can be cast in terms of the bargaining game. In addition to defense spending and aid (standard instances of "burdensharing"), there are issues of monetary and financial policy, protectionism, regional trading blocs, and foreign direct investment. But in virtually every case, this paradigm is crippled by a simple problem: a lack of general agreement as to whether the spending or other policy measure under consideration is properly considered a public good or a public bad.

Beginning with the case of defense spending, Americans naturally assume that their own defense spending is a public good, but not everyone agrees. Shafiqul Islam raises the possibility that it may be a public bad. More importantly, as several conference participants pointed out, Americans, Japanese, and Asians cannot agree—even among themselves, let alone with each other—whether Japanese defense spending is a public good or a public bad. Identification of Japanese military spending as a public bad was clear during the American occupation, when the United States imposed the peace constitution. But Americans today accuse Japan of free riding on United States defense spending. The United States evidently has changed its mind in response to changed circumstances. One wonders, however, how Americans would react to a full-fledged Japanese military buildup. There is no doubt that most Asian countries would be alarmed, as Islam, Wing Thye Woo, and others point out.

In game theory terms, we may be playing the game illustrated in table 2, where defense spending is a public bad. Here the noncooperative solution is for both players to increase spending—the arms race that is all too familiar from history. The cooperative solution is for both sides to reduce arms expenditures. Here "cheating" on a cooperative agreement means spending more than the other party, not less.

American complaints that Japan is not living up to its international commitments because it is spending too little should be viewed in a special light, if the level of spending is the outcome of a bargain urged on Japan by past American governments in the belief that it would be in everyone's interest, as Islam points out. Similarly, any future American (or Asian) complaints that Japan is spending too much on defense will have to be viewed in a special light to the extent that the increased spending is the outcome of bargains urged on Japan by American governments. The conclusion is that it is difficult to apply the game

Table 2 **When Spending on Defense Is a Public Bad**

	United States cuts spending	United States increases spending
Japan cuts spending	Cooperative solution	United States perceived as aggressive
Japan increases spending	Japan perceived as aggressive	Arms race: overprovision of public bad

theory paradigm if we are not sure among ourselves whether Japanese defense spending is good or bad.

One might think that Japanese official development assistance (ODA), such as assistance to Southeast Asian countries in developing infrastructure, would be a clear public good, especially if it is conducted via a multilateral lending institution such as the Asian Development Bank. But some observers question whether such aid is benign. It is suggested explicitly that Japan uses such aid in its own economic interest, and it is suggested implicitly that this trend may not be in the interests of the recipients or other participants in the regional economy, such as the United States.

Other public goods issues arise in the financial area. The policy of the U.S. Treasury, beginning with the 1984 Yen-Dollar Agreement, has been that Japan should promote international use of the yen (for example, in the invoicing of trade, denomination of loans, and use by central banks) and that yen internationalization is a public good. Jeffry Frieden adds banking regulation and monitoring of international lending to the list of supposed public goods in the world financial system. Yet, he points out, it is far from clear that internationalization of the yen is in fact in anyone's interest. Except, perhaps, the interest of Japan: the Yen-Dollar Agreement was perhaps the first major example of Takatoshi Ito's second type of United States–Japan bilateral negotiations. The United States makes demands on Japan that are not obviously in America's interest, but rather, if anything, in Japan's interest, and Japanese leaders use the *gaiatsu* (foreign pressure) to bring about useful reforms. The 1990 Structural Impediments Initiative is the best example of this type of negotiation (Frankel 1990).

Contributing to the maintenance of open international markets is a clear public good. One would expect the issue of cooperation in the trade area to come up most clearly in connection with GATT, specifically the Uruguay Round of trade negotiations, because this is the major international institution for cooperation on trade issues. Japan has been a supporter of the Uruguay Round. But a true test of the strength of its commitment to the liberal trading regime, particularly on the question of rice imports, has been repeatedly postponed by the failure of the Europeans and Americans to come to an agreement on agriculture. Partly because of this delay and partly because many view GATT as passé, attention has shifted to other aspects of trade.

The formation of a Pacific Asian trading bloc, which is the focus of the first four contributions to this volume, can be viewed in light of the public goods paradigm. Formation of a trading bloc, by such steps as preferential trading arrangements among the countries of a region, can hurt the rest of the world by diverting trade away from nonmembers. The classic proposition of Jacob Viner is that world efficiency is improved if trade creation within the bloc is greater than trade diversion. Krugman (1991b) reviews reasons why nonmembers may be made worse off. First, the presumption is that there will be a shift in demand and therefore in the terms of trade away from nonmembers, even with no increase in the level of trade barriers, such as tariffs, applied against them. Second, if each political unit sets its level of trade barriers in an economically maximizing way, the formation of a trading bloc will lead to a higher level of barriers against the rest of the world. The grouping has an enhanced incentive to protect, as it seeks to exploit a degree of joint monopoly power that is greater than that possessed by the individual countries. This is a clear prisoner's dilemma situation, as other regions of the world have an incentive to retaliate by forming their own trading blocs, raising barriers, and exploiting their own monopoly power. In this model (Krugman 1991a), the formation of trading blocs is a public bad (and an equilibrium of three blocs turns out to be particularly bad!).[9]

"New wave" international trade theory, which emphasizes imperfect competition, increasing returns to scale, and endogenous technology, has reinvigorated questions of strategic trade policy with findings that unilateral U.S. government activism can under certain conditions pay off (such as subsidizing aircraft manufacture, where oligopolistic rents are important, or semiconductors, where learning-by-doing is important). But in each case, the logic generally leads to the conclusion that the Nash noncooperative equilibrium in which the United States, the European Community, and Japan *all* subsidize aircraft or semiconductors is an equilibrium in which everyone is worse off, contrary to widespread impressions. New wave trade theory is a strong argument in favor of worldwide cooperation to refrain from such activity, in favor of negotiation and enforcement of international agreements such as GATT.

These implications of the theory extend to trading blocs. Everyone will be better off under an international agreement that forbids regional organizations from seeking to exploit their monopoly power. GATT adopted the most-favored nation principle and allowed for deviations from it to form free trade areas only under certain restrictions. GATT's Article 24 forbids, for example, an increase in tariffs by regional trading arrangements. Those rules have been bent in Europe, the Western Hemisphere, and other parts of the world. Japan does not in fact have any sort of preferential trading arrangements in Asia, so that the issue of GATT compatibility does not arise. As noted above, the au-

9. But Krugman (1991b) can just as easily come up with a model (one in which transportation costs between continents are extremely high, in contrast to his earlier model where they are assumed to be zero) in which a world of trading blocs is good. If this type of model is the right one, then a regional power, such as Japan in Asia, the United States in the Western Hemisphere, or Germany or France in Europe, who is large enough to take the initiative to organize a trading bloc is doing a public service. Once again, we have trouble telling a public good from a public bad.

thors in this volume endorse the view that trade in East and Southeast Asia, in contrast to North America and the European Community, does not demonstrate a trend toward intraregional concentration. To the contrary, Japan and other East Asian economies remain highly dependent economically on trade with North America.

Kenneth Froot and David Yoffie add foreign direct investment to a model of the Krugman type, where the formation of a trading bloc is a public bad because of the incentive to raise protectionist barriers. Their conclusion is that, when a bloc lets in such investment, it creates a constituency for trade liberalization and reduces its incentive to protect. Here a country's willingness to let in direct investment is a public good. This logic naturally leads to concerns about Japan, as far more direct investment is seen originating in Japan than entering there.[10] On the other hand, fears of domination by foreign investors often have more of a home in populist politics than they have a basis in reality. Some point out, in contrast to the Froot-Yoffie argument, that a country that is host to foreign direct investment has a ready hostage that increases its bargaining power, whether in economic or military competition.[11] This argument suggests that it is Japan, not its Asian neighbors or the United States, that should fear a vulnerability arising from transplanted Japanese firms on foreign soil. Concerns about sensitive technologies can amplify the case for the United States to encourage Japan to locate operations in the United States.

It is striking that in so many of the most significant issues—military spending, ODA, internationalization of the currency, regional integration, foreign direct investment—Americans (and Asians) have trouble agreeing whether they want Japan to do more or to do less. In some areas of policy, public goods can more easily be distinguished from public bads. This should be the case in areas of environmental protection, weapons proliferation, and human rights, which were not examined in this project. Even in these areas, however, different countries have different views about the relative importance of protecting marine mammals versus addressing global warming, of reducing the arsenals of the superpowers versus slowing proliferation to developing countries, or of protecting free speech versus accepting refugees.

Japanese are themselves divided over many of these issues. In some cases the outlines of the political divisions within Japan are strikingly similar to divisions within the United States and other countries. The debate between those in favor of a renewal of Japanese military capability and those opposed is a Right-versus-Left debate that is familiar from recent history in the West. Frieden points out that the debate between internationalists and nationalists in Japan (or what Funabashi [1988] calls internationalists and domesticists) is analogous to debates in the United States, particularly in the 1920s when it

10. As pointed out by Dennis Encarnation (1992), among others at the conference.

11. Graham and Krugman (1991). This argument was also made by Robert Lipsey at the conference.

was the isolationists who carried the day. Frieden argues that the internationalists may be gaining the upper hand in Japan, just as they eventually did in the United States during the 1940s. Even the alignment of economic interest groups is often similar in Japan and the West: nationalist farmers oppose economic liberalization, by appealing to the much larger urban population with nostalgic recollections of the country's cultural traditions, while internationalist financiers support economic liberalization, by appealing to the country's international obligations.

In other respects the outlines of political divisions in Japan are different from those in the United States. Ito points out the importance in Japan of a division between bureaucrats and politicians, as compared to a division in the United States between a market-oriented White House and a trade-hawk Congress. Institutional specifics are important in each case. In Japan the method whereby districts choose members of the Diet encourages candidates to cater in direct economic ways to special interest groups, as Frances Rosenbluth emphasizes in her comment. But at least the Japanese social system, through the process of *nemawashi* (consensus building), allows the country to speak in the international arena with a relatively unified position. In the United States, divided government has precluded the country from speaking to its trading partners with a single voice. Such divisions in each country lead to what Putnam (1988) calls two-level games: any internationally agreed position must be ratified by the domestic groups who are enfranchised on a given issue.

Japan and the United States as Leaders in Pacific Asia

The ambiguities in a public goods analysis of collaboration between the United States and Japan in Pacific Asia lend support to predictions that development of joint leadership in the region will prove difficult or impossible. Neorealist analysis, in which narrowing power differentials produce heightened conflict, could suggest an even more pessimistic view—that overt United States–Japan conflict is inevitable. Two features of the present international situation might be singled out in this view in support of this bleaker image of the future. The dissolution of the Soviet threat will place pressure on the United States–Japan security relationship—alliances do not long survive the threats that called them into being. Equally important, as Japan increases its economic weight and technological capabilities, a logic of relative gains will—in the absence of a common enemy—swamp the joint interests that the two countries still have in the region and undermine collaboration. A United States fearful of its new economic challenger will increasingly view Japanese success and initiative as a threat, even though American pressure may have originally encouraged Japanese assertiveness.

Despite this forbidding possibility, broad agreement between the two powers in their aims for Pacific Asia is likely to prevent any leap from present-day levels of cooperation to open conflict or mutual perceptions of threat. Both countries still share a strong interest in maximizing the extent to which people in this region are living in stable, democratic, market-oriented societies that do not impose negative externalities or spillovers (such as pollution or weapons proliferation) on other countries. Conflict has already occurred and remains very likely, however, in designing a structure of joint leadership in the region that will maximize these goals. In part, the difficulty lies, as described above, in defining the precise policies to be undertaken by both the United States and Japan and the relative sharing of the burdens, both military and economic, of a leadership role. More important, a stable structure of joint leadership will require wrenching political adjustments on both sides in order to construct a political base for that structure, a base as stable as the existing supports for an alliance relationship that is now under strain.

Americans worry that Japan is not ready politically to take on the leadership role that would be commensurate with its economic importance. Some Japanese share this concern and would prefer the United States to remain the leader. Frieden's account of America's disengaged international stance in the 1920s and 1930s poses the possibility that Japan will shift toward greater leadership and that the transit may take some time. The Japanese political system, in particular, is already demonstrating the difficulties of adjusting to a new role. The old "Yoshida line" held that Japan's international business would be business. Many Americans and Japanese alike (e.g., Ito, chap. 9 in this volume) worry that Japan continues to lack the ideals or principles required for international leadership. To the degree that it has a national ideology, it is based on the hoarding of technology (as David Friedman and Richard Samuels argue in this volume) or on a simple sense of national uniqueness.

New internationalists such as Yoichi Funabashi and Shinichi Kitaoka now argue that Japan should break from the Yoshida line and pursue a more active international policy based on such fundamental principles as promoting democracy, economic development, and environmental protection. This school is an encouraging alternative to the traditional extreme choices of Right and Left: on the one hand, Shintaro Ishihara and others who argue for a strong independent international presence but arouse suspicions of resurgent Japanese militarism; on the other, unreconstructed socialists who have long opposed any Japanese military capabilities and distrust American hegemony and whose economic ideology has never come to terms with the facts of East Asian dynamism. When Kiichi Miyazawa became prime minister, it was thought that he might break from the Yoshida line. But he encountered deep and persistent resistance in his efforts to push new initiatives—such as involvement by Japan in peacekeeping operations—through the scandal-weakened Japanese political system.

The United States must undertake an adjustment equal in difficulty to that of Japan. Americans must adjust to the fact that sharing leadership with Japan does not mean simply sending Tokyo the bill, whether it is for military operations in the Middle East or financing for troubled debtor countries. As C. Fred

Bergsten has said of transfers to the United States in connection with the 1991 Gulf War, "We now know the definition of collective leadership: the United States leads and the United States collects."[12] Saudi Arabia and Kuwait paid the most, followed by Japan, Germany, and the United Arab Emirates in that order. The total, with $37 billion of international commitments actually received by mid-1991, was enough to wipe out the United States trade deficit in goods and services in the first half of the year and produce a small surplus on the overall current account.

The United States must grant Japan a share of power in decision making that is commensurate with its financial contribution. "No taxation without representation" is not simply an ideal of American democracy; it is also a positive statement that a people who are denied a say in how their money is spent will eventually refuse to continue paying. In concrete terms the United States may need to support granting Japan expanded voting power in the Asian Development Bank, top management positions in the International Monetary Fund or the World Bank, and a permanent seat on the United Nations Security Council. Greater attention will be required to the alternative model of economic development that Japan has begun to offer in the International Monetary Fund and the World Bank.

Several of the authors in this volume make clear that it is the American political system that may prove the most recalcitrant to the demands for a new structure of joint leadership in the region. Perhaps the worst outcome would be an American withdrawal from Pacific Asia after assessing few economic gains (given Japanese ubiquity in the region) and many, largely military, costs. Such a policy shift could induce both a "hardening" of regional structures under Japanese leadership and eventually a remilitarization of Japan. This negative dynamic works primarily through American perceptions as played out in the American political process. But if the domestic adjustments in Japan and the United States are successful—a daunting prerequisite—then there are reasons to believe that conflicts over leadership and burdensharing in the provision of public goods may persist at only at a relatively low (and familiar) level.

Many of the international public goods to be provided are not regional but global, and Western Europe, particularly Germany, is as likely to be the target of American displeasure as Japan. (This was the pattern after the Gulf War.) The end of the Cold War means an erosion of common agreement on external security threats and divergence over defining public goods and bads, as described earlier. But the more relaxed security environment also means that the most contentious public good—military security—can be provided at lower levels. It is also worth noting that a suboptimal provision of international public goods, however defined, need not mean chaos or catastrophe in every instance. For example, should the Cambodian peacekeeping operation break down be-

12. "Burdensharing in the Gulf and Beyond," testimony before the House Committee on Ways and Means, 13 March 1991.

cause Japan and the United States are unable to agree with the other interested parties on an acceptable sharing of military and economic costs, the Cambodian people will face continued military conflict and much collective suffering, but the rest of the Pacific Asian region could continue its economic progress with little effect.

Finally, it is worth considering the perspective of the other countries in the region on the balance between cooperation and rivalry in U.S. relations with Japan. Intensified conflict at the levels of the 1930s would clearly be damaging to the development prospects of societies in the region. On the other hand, a certain degree of competition between the United States and Japan may be beneficial. Duopoly power awarded the United States and Japan by a structure of close collaboration in, for example, the provision of development assistance or the management of trade, may not be the preferred outcome for smaller countries economically dependent on American and Japanese capital and markets. For lesser powers in the region, a preferred future order for Pacific Asia may be one of restrained competition between the two economic giants, not two-power condominium, one-country dominance, or unbridled rivalry.

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