Executive Summary

From the early 1960s, the Western policy community has been confounded by two questions concerning Japan. First, what accounts for the economic success of Japan? Second, how to deal with Japan's trade success? The Western response to Japan's re-emergence on the international scene has hit one snag after another. Informal trade restraints and bilateral "fixes" have largely by-passed the real problems.

There should be no mystery behind Japan's economic growth. Japan got most of its economic fundamentals right over an extended period of time. By seeking out examples of Japan's alleged trade and economic "deviousness" and cultural impediments, the West's response to Japanese trade success has been fundamentally flawed. Consequently, Japan-U.S. trade frictions have grown and economic nationalists in both countries have fed on them. This Paper argues that, rather than demonizing the Japanese, policy makers need to recognize Japanese strengths more honestly, target specific trading and investment distorting practices (which <u>do</u> exist), and accept that Western regimes also retain important protectionist features that, <u>grosso modo</u>, can and do distort trade and international investment flows. Further negotiations to liberalize these barriers are still required.

This Paper builds on a recently released companion document "And the Devil Take the Hindmost: The Emergence of Strategic Trade Policy" (No. 93/14). The objectives of the present Paper are to (a) discuss the nature of Japan-U.S. trade frictions and the measures adopted to resolve them; (b) review economic arguments that explain post-War growth in Japan; (c) discuss why bashing Japan with trade management measures will most likely not work; and (d) draw lessons from Japan's economic success and from the purported U.S. economic decline (which fuels Japan-U.S. trade frictions).

This Paper finds that there are sharp institutional differences between Japanese and U.S. markets. This is borne out in everything from the distribution system to the network system among companies to the financial role of banks. Some of Japan's markets appear to be characterized by cartel type arrangements between firms that may make it difficult for outsiders, including foreigners, to break in. However, there are real efficiency advantages to the Japanese style of business, arising from the virtues of long-term relationships, a flexible labour market and flexible manufacturing or corporate process "reengineering".

As a small island lacking natural resources, Japanese society has focused on manufacturing as the backbone of its economy. To import raw materials, it had to be export-oriented. To transform raw materials, it needed capital stock and technical know-how. The capital stock it accumulated has been financed by its high propensity to save. Technology it actively sought and often imported from the West. To produce new knowledge, it invested