Statement Before the U.S.-China Economic and Security Review Commission

by Eamonn Fingleton, author of "Unsustainable: How Economic Dogma is Destroying American Prosperity" (New York: Nation Books, 2003).

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For more than a decade now we have been told that it is inevitable that high-wage nations like the United States will be hollowed out by a rising China. This is dangerous nonsense that has already done untold damage to the United States.

Although China has every right to aspire to become rich, other nations should not be expected in response to have to weaken their industries, let alone impoverish their manufacturing workforces. If this point is not understood in the United States, it is well understood elsewhere, not least among China's richest trading partners in East Asia. In varying degrees, South Korea, Taiwan, Singapore and Japan have cooperated with China's desire for export-led growth yet they have done so without compromising their own fundamental economic interests.

The experience in Japan, where I have lived for nearly twenty years, is particularly instructive. It is a little known fact that wages in Japan are actually higher than in the United States -- about 20 to 30 percent higher measured at recent market exchange rates. Yet even as Japan has rapidly increased its imports from China, it has shown no evidence of being hollowed out. Quite the reverse. Japan's industrial strength has, on balance, actually been considerably enhanced by trade with China in recent years.
Certainly Japan's trade surpluses have continued to burgeon. Japan's current account surplus last year, at $181 billion, was not only the largest of any nation in world history but it was more than three times Japan's current account surplus in 1989, the last year of the Tokyo financial boom.

It is interesting to note that China supplied full 20.7 percent of all Japan's imports in 2004, compared to a mere 13.4 percent of America's. Measured in yen, Japan's imports from China increased by 263 percent in the ten years to 2004.

Just as in the case of the United States, outsourcing from China has played a major role in the rise in Japan's imports in recent years. There the similarity ends. Unlike the United States, Japan believes in managing its trade. Although Japanese officials recognize, of course, that consumers can benefit considerably from trade, they also recognize that people need jobs and incomes before they can consume. Thus where imports would pose a significant threat to jobs, the Japanese government generally acts to minimize the damage. It does so typically by issuing guidance to key players in, for instance, the Japanese distribution system to minimize their purchases of the relevant imports.

Where outsourcing is concerned, a second key concern for Japanese policymakers is to keep tight control of the nation's key production technologies, thereby maximizing Japan's productivity edge. It is taken for granted in Japan that production technologies are as much the nation's property as they are the property of the corporations that developed them. Thus individual corporations are not permitted unilaterally to transfer advanced technologies to foreign operations. The sense that the technologies are national property is enhanced by the fact that they are typically developed jointly by Japanese corporations in industry-wide research cartels. It is assumed by all concerned that the latest technologies will be applied in the first instance in factories at home, thereby giving Japanese workers a vital edge in global competition. Any decision to move the technologies abroad will be the result of a government-guided industry consensus. Thus although corporate Japan has transferred significant production technologies to China in recent years, it has never given away the crown jewels.

Much of the control of Japanese trade stems automatically from the nation's distinctive labor regulation. A basic principle is that employers should avoid making layoffs. This principle is applied flexibly -- in the Japanese way, bureaucrats are entrusted with extraordinary case-by-case discretionary powers. Thus exceptions to the no-layoff policy are permitted, particularly in the case of small firms and corporations in near-terminal financial difficulties. But for large, solvent corporations, layoffs are generally not permitted.

In practice therefore the operating assumption in corporate Japan is that payroll is a fixed cost. This profoundly alters how Japanese top managements see their responsibilities. Thus whereas in corporate America, profits come way above jobs in a CEO's priorities, in corporate Japan the ranking is exactly reversed. It is useful to see the world as the chief executive of a major Japanese corporation sees it. Whereas his American counterparts are much concerned with pandering to the whims of securities analysts and micromanaging quarterly earnings flows, a Japanese CEO is necessarily focused on long-term production planning. His principal concern is to create new and ever more productive work for his Japanese colleagues at every level in the organization. Not the least of his concerns will be to ensure the viability of the jobs of the thousands of young workers recruited this year, workers who can be expected to be still on the payroll thirty years hence. Towards this end he will want to make sure that the corporation spends heavily on research and development and that this spending is directed principally towards developing new production technologies intended to give his workers a productivity edge in world competition for decades to come.

All this means that a Japanese CEO's attitude to outsourcing will almost automatically be closely aligned with the Japanese national interest.

Because he cannot easily shed labor at home, he will move production activities abroad only after he has already lined up new and better work for his domestic workers. By new and better work is meant work that is either more capital intensive or more know-how-intensive or both.

By way of example, a Japanese television manufacturer might move assembly operations to China only after it had first determined to redeploy its domestic assembly workers making sophisticated components such as liquid crystal displays. The significance of this shift is apparent when you realize that the manufacture of components is often ten or even twenty times more capital intensive than assembling television sets. It also often involves an enormous amount of secret production know-how that can give Japanese workers an enormous edge in global competition. In the case of liquid crystal displays, the importance of production know-how can be readily demonstrated. A liquid crystal display consists of perhaps as many as a million separate dots each controlled by a separate transistor. If the display is to be a saleable product all the dots and transistors must work perfectly. If there is any deviation from perfect conditions in the factory, there will be a significant number of dysfunctional transistors and the resulting displays will have to be scrapped. By dint of learning by doing over thirty years or more, Japanese LCD manufacturers have so honed their production technologies that they can secure a yield of perfect products of as much as 90 percent in a typical production batch. By contrast any new entrant into the field -- say a Chinese company or an American one -- would probably be lucky to get a yield of as much as 10 percent. In other words, Japanese workers by dint of their employers' superior production know-how can readily out produce workers abroad by a factor of nine to one. For Japanese CEOs, the availability of cheap Chinese assembly labor has on balance been a major plus because it has made possible a highly efficient division of labor. Released from labor-intensive assembly functions, workers at home increasingly concentrate on making sophisticated components.

Thus the rise of outsourcing in China has enabled Japanese corporations, (1) to increase greatly their total unit output, (2) to redeploy their home workers in ever more productive work, (3) to cut unit costs and unit prices, thereby expanding ever further the global market for their products. All this helps explain the fact that though Japan has now been ostensibly eclipsed by China in exports to the United States, the Japanese are not complaining. In reality much of the most sophisticated value added in China's exports originates in Japan.

Below is an article, which will be published in May in The American Prospect.

Rediscovering Asia's real powerhouse
By Eamonn Fingleton

For those who claim an above average knowledge of the global economy, here's a question: which East Asian economic powerhouse recently announced the largest current account surplus in world history?

The answer is, of course, Japan. Not that readers of the American press would have noticed. Given the press's obsession with China, little about East Asia's other economic powerhouse makes it into print these days. Yet in most of the ways that matter to current American economic policy, Japan is far more important than China.

To be sure China is growing very fast. But all misinformed American commentary to the contrary, China remains a long way from displacing Japan as Asia's largest economy. Still less is China any sort of benchmark against which a high-wage economy like the United States should be measuring itself.

Japan by contrast is avowedly such a benchmark. A fact utterly lost on the American media is that Japanese industrial wages are now among the world's highest. They are not only far higher than in China -- about four to fifteen times higher depending on the region of China -- but they are actually 20 to 30 percent higher than in the United States. Yet Japan's export industries have not only survived but also thrived.

The largely untold story of Japan's extraordinary manufacturing successes of recent years should inspire a radical reappraisal of fundamental American economic assumptions. Certainly Japan's trade performance stands as a stunning rebuke to those who hold that high-wage nations can no longer compete in manufacturing. Their argument has fostered an utterly unwarranted sense of inevitability about America's manufacturing implosion. Just how much damage has already been done can be gauged from the fact that, at more than 5.6 percent of GDP, America's current account deficit last year was proportionately the second worst of any major economy in history. It was exceeded only by Italy's 7.7 percent deficit in 1924 -- hardly a happy precedent given that Mussolini seized dictatorial powers in January 1925.

Let's get Japan's true economic standing into perspective:

1. Translated at market exchange rates Japan's gross domestic product last year came to $5.1 trillion -- three times China's $1.7 trillion.
2. Japan's current account surplus last year, at $181 billion, was more than two and a half times China's. Even more impressively it was more than three times what Japan earned in 1989, the last year of the Tokyo financial boom. (Full disclosure: Japanese officials are now worried that, thanks to higher oil prices among other things, the surplus could dip as low as $145 billion in 2005. But Americans need shed no tears. This would a nice contrast moreover with the last time oil prices last seriously cramped Japan's mercantilist style: in 1980, after all, Japan incurred a ***deficit *** of more than $10 billion.)
3. Despite the fact that the United States now buys about one-third more from China than from Japan, the Japanese are hardly complaining. On the contrary, Japan makes most of the high-tech components and materials in China's exports. Japan's know-how-intensive and capital-intensive factories are using China (as well as dozens of other nations) as an export pipeline to the United States. Judged by where the added value is really created, Japan is still a far larger source of U.S. imports than China.

How can all this be reconciled with the press's account of a perennially ailing Japan? It can't, of course. Japan is no basket case and never has been. Strange as it may seem, for many years Japanese leaders have -- for very Japanese reasons -- been assiduously exaggerating Japan's weaknesses and understating its strengths.

Perhaps the biggest surprise is how rich Japanese consumers have now become. Their affluence is immediately obvious in how they dress. Already considered the world capital of fashion by such style mavens as Suzy Menkes and Amy M. Spindler, Tokyo was recently pronounced "the coolest city on the planet" by the editors of GQ magazine.

As UCLA management professor Sanford Jacoby points out, Japan's prosperity is also abundantly apparent on the roads, which are full of late-model cars, and in its electronics stores, which are perennially packed with free-spending males. Indeed the Japanese are so rich that many of the most advanced new products -- everything from the latest game machines to the most spectacular new flat-panel television screens -- are launched in Japan months or even years before they hit the United States.

"Japan is a very affluent country with an income distribution much less unequal than in the States," says Jacoby, author of a new book on Japanese corporate governance. "Those in the bottom two-thirds of the income distribution enjoy a higher quality of life than their U.S. counterparts. As for the upper one-third, they too benefit from Japan's high level of public services as well as the security that comes from a stable, cohesive society."

Even in the late 1990s, when commentators abroad were daily performing the last rites for the Japanese economy, the palpable prosperity on the ground in Japan stunned visiting Americans. A typical recollection is that of Nathanial (stet) Gronewold, a Minneapolis University graduate who studied economics in Hiroshima in 1997 and 1998. He says: "My time in Hiroshima went down in the record books as two of the worst years for Japan's economy. But the affluence I witnessed in and around Hiroshima was a stark contrast to the scores of empty storefronts and offices in downtown Minneapolis, which was supposed to be booming at that time."

Although Japan's real estate crash early in the 1990s has received plenty of attention, the veritable boom in construction that Gronewold witnessed in Hiroshima was no isolated phenomenon. As measured by the architectural website skyscrapers.com, 80 skyscrapers were built in Tokyo in the 1990s, versus just 49 in the 1980s (skyscrapers being defined as buildings rising at least 35 meters). In Osaka the total was 56 versus 18; in Yokohama, 19 versus none. By comparison London's total was 33 versus 28. Meanwhile New York actually registered a decline: a mere 103 skyscrapers built in the 1990s versus 257 in the 1980s.

Here are a few other examples of how well Japanese consumers have been doing:

* Car navigation systems. With 3 million systems sold annually, Japan is by far the largest market for these invaluable gadgets. (They use satellite technology to pinpoint a car's position, suggest routes, provide alerts on traffic jams, and generally take much of the second-guessing out of getting from A to B.)
* The Internet. As reported by London-based Total Telecom magazine, Japanese Internet connections are now not only the fastest in the world but the cheapest. Investing more heavily in optical fiber networks than almost any other nation, Japan now leads the world

in so-called FTTH (fiber to the home).
* Mobile phones. Japan has come from nowhere in the early 1990s to establish a lead of 25 percent over the United States in the rate of mobile phone ownership. Japanese mobile phone networks now lead the world in service quality. Thus camera-equipped phones took off in Japan as far back as 1999. Ditto for "I-mode" service -- the ability to access the Internet via mobile phone. Already by 2003, according to the Virginia-based consulting firm TMG, 29.5 percent of the Japanese population enjoyed I-mode service. Such access was still almost unknown in the United States.
* Health care. Boasting one of the world's better universal health care systems, Japan has cut its infant mortality by more than one-quarter since 1990 to just 3.28 per 1,000 live births. Less than half the American rate and a mere one-seventh of China's, this constitutes a world record low. And, despite the fact that the Japanese have been eating more and more unhealthy Western food, they are living longer than ever. Female life expectancy at birth is now 84.5 years, an increase of 2.7 years since 1990. The Japanese now live four years longer than Americans, and eleven years longer than the Chinese.

If Japanese consumers have made remarkable progress in recent years, the advances in Japanese industry have been stunning. Thanks to consistently heavy investment, Japan has made huge strides in industrial productivity. Thus, as Fortune recently reported, Toyota Motor seems set to pass General Motors within the next two years to become the world's largest auto maker. By contrast in Japan's "juggernaut" era of the late 1980s Toyota was still being out-produced more than two to one by General Motors and more than 50 per cent by Ford.

Japanese workers these days typically work with ten to twenty times the capital of their Chinese counterparts. For the most part therefore the Japanese and the Chinese are positioned at opposite ends of the manufacturing spectrum -- a spectrum moreover that has never been wider. The Japanese worker's huge productivity advantage is well illustrated by the fact that, on latest CIA figures, Japan is home to 57 percent of all the world's industrial robots.

Underlying all this has been a national strategy to out-invest all foreign competition. The result is that, utterly overlooked by the American press, Japan has established monopolistic leadership in more and more areas of advanced manufacturing, particularly in producers' goods such as materials, components, and machine tools. Almost invisible to the consumer, such monopolies constitute "chokepoints" which give Japan control over ever-larger swathes of the global industrial landscape.

One such chokepoint is Japan's little noticed but geopolitically important lock on advanced lens cutting. Leadership in lenses helps explain why Japanese companies dominate the world market in everything from television studio equipment to endoscopes. Lens technology even gives Japan a crucial inside track in semiconductors. The point is that advanced lens cutting is the single most important technology in creating so-called steppers, the photolithographic machines that print minute electrical circuits on silicon chips. Japan's champion lens-cutters, Nikon and Canon, make more than two-thirds of the world's steppers.

Japan also monopolizes such important semiconductor production equipment as photomasks, as well as key materials such as silicon, gallium arsenide, and epoxy cresol novolac resin (ever purer versions of which are needed for each new generation of computer chips).

Elsewhere in the electronics industry Japan's hidden chokepoints include charge coupled devices (essential in everything from home video cameras to guided missiles), high-tech batteries (vital in many portable devices, not least military equipment), and laser diodes (the enabling technology in, for instance, the ever growing CD/DVD family of gadgets). In miniaturized disk drive motors, Kyoto-based Nidec has 90 percent of the world market. Its highly precise, almost silent, motors are the enabling technology in the Apple iPod.

In mobile phones, the Japanese are quietly dominant. Although Western brand-names like Motorola and Nokia appear to lead the industry, today's sleek mobile phones would not exist without Japan. Japanese electronics makers embarked on a massive government-led effort in the 1970s and 1980s to miniaturize the various components. A survey by Deutsche Bank found that as of 2000 of 36 suppliers of the nine key components in mobile phones, 29 were Japanese. Japan also owns most of the world's optical fiber production capacity.

Even in the pharmaceutical industry, where the Japanese are generally regarded as also-rans, Ajinomoto supplies 60 percent of all amino acids. It also makes 70 percent of all threonine, a vital ingredient in animal feeds, as well as 40 percent of all aspartame.

Perhaps the single most surprising area of Japanese industrial success has been aerospace. After decades of quietly capturing key chokepoints in avionics, carbon fiber, and titanium, Japan has now passed a fast declining United States in all but name. One indicator is that, as officially acknowledged by Boeing, Japanese contractors will build 35 percent of the new super-advanced Boeing 787, a big jump on their 21 percent share of the Boeing 777. In the view of independent experts, the 787 will be more a Japanese plane than an American one.

Although it is impossible in a few paragraphs to do full justice to Japan's progress in recent years, it should be clear by now that the "lost decade" story was a hoax. In truth the Western media have been blindsided by a 180-degree reversal in Japan's public relations program. Whereas in the 1980s Japan had aggressively emphasized its strengths (some real, others imaginary), it switched in the 1990s to a highly counterintuitive "bad news" strategy.

The up-beat propaganda of the 1980s had been intended primarily as a defense in dumping suits. Hence, for instance, a bogus claim, much aired in the American media in the 1980s, that Japanese car-makers were supposed to be more than ck ten times more productive than their American peers.

Japan's propaganda needs changed abruptly once major American corporations laid off their factory workforces and switched to outsourcing. As companies like Hewlett-Packard and Motorola stopped competing with the Japanese and started buying from them, a new era of U.S.-Japan corporate partnership emerged in which the dumping suits disappeared. Meanwhile America's trade deficits with Japan widened rapidly, prompting Washington to view Tokyo more and more as a power rival. In the new circumstances, Japan's old super-economy image was not so much an irrelevance as a liability.

Washington's mood softened remarkably, however, after the Tokyo stock market crashed in 1990. Assuming quite wrongly that the crash signified fundamental problems in Japan, Washington began expressing gentlemanly concern for the "fallen giant."

Never slow to spot an opening, Japanese leaders soon found other sob stories to tell. In an early gambit, officials reversed Japan's vagrancy policy. In the 1980s they had carefully kept Japanese cities miraculously free of vagrants, thus fostering a myth that Japan was immune to the pathologies of lesser societies. In reality, as James Fallows documented, down-and-outs had existed all along in Japan. Up to the early 1990s they had been kept hidden in special remote ghettos such as the Sanya district of Tokyo. The new "bad news" strategy called for a radical change: now down-and-outs were given carte blanche to camp out in Tokyo's glitziest neighborhoods, such as the park opposite the toney Imperial Hotel.

Another official gambit was to adopt highly conservative national accounting assumptions, which drastically choked back Japan's apparent growth rate. Hence the fact that, though both Japanese living standards and exports have palpably boomed in the last fifteen years, annual GDP growth is officially stated to have averaged only about 1 percent.

Meanwhile officials began beating their breasts about an apparently disastrous deterioration in public finance. One "footnote" has been omitted: Japan's official foreign exchange reserves rocketed from $85.1 billion in 1989 to $840.6 billion at last count. In effect the Japanese government has been borrowing to prop up not the Japanese economy but the American one.

Some of the sob stories had a basis in truth, but nonetheless greatly exaggerated the real trauma. Take the banking crisis. This present writer was virtually alone among Tokyo-based observers in the 1980s in predicting the banks' problems. These duly emerged in the early 1990s but, pace all misinformed alarmism in the American press, Japan never came close to a domino-style banking collapse.

Far from countering the alarmism, many prominent corporate chieftains compounded the jitters. In 1998, for instance, the president of Toyota Motor made world headlines when he suggested that a collapsing Japan could take the world financial system with it. This remark seemed on its face inexplicable. Certainly no one climbs to the top of a major corporation anywhere, least of all in Japan, by shouting "Fire!" in a crowded theater. Of course, if all the dramatis personae in the Japanese establishment knew that the fire was merely part of a kabuki act, that would be different...

What is clear is that nothing in Toyota's own business experiences remotely justified the remark. In fact Toyota's profits in 1998 represented a healthy 56 percent advance compared to 1989, a performance that put Ford and General Motors in the shade. The home market in Japan moreover had remained profitable as household car ownership increased by 2.2 million in the 1990s. The cars moreover had become much larger and more luxuriously fitted, with the svelte Toyota Lexus, for instance, replacing the dowdy old Toyota Century as the executive limousine of choice.

If Japanese leaders put on a convincing impression of economic decline in the 1990s, it has to be admitted that Western commentators made a gullible audience. Many press correspondents wailed about corporate Japan's low profits. And sure enough profits are low in Japan. What the correspondents have not understood is that in the Japanese system -- whose workings are consistently misunderstood by foreigners -- profits are a secondary consideration. That may seem surprising but the fact is that even in the "juggernaut" years of the late 1980s Japanese corporations were notoriously unprofitable.

In general the further people were from Japan the more extreme their statement of the "basket story." Take New York-based Karen Elliott House, who in 1992 compared the Japanese economy all too gleefully to children's toys called Shrinkies, which were advertised to "shrink right before your eyes." In a similar outburst of misplaced schadenfreude, Paul Krugman recycled unchecked a myth that Tokyo had been reduced to building "bridges to nowhere" and "roads with no traffic" to stimulate the economy. Japan has no bridges to nowhere; and it is hard to build unnecessary roads in a nation with one of the highest ratios of cars to road space in the world.

For sheer absurdity few observers came close to Michael E. Porter. In a book entitled "Can Japan Compete?," Harvard's competitiveness oracle persuaded himself that Japan had ceased to innovate by the mid-1980s. Thereafter its export drive had allegedly become increasingly dependent on industries so laughably low-tech they would embarrass an Afghanistan or a Peru. Among these were yeast, flaked cereal, and, most memorably, "raw bovine and equine hides"! For some reason Porter's list overlooked all the hundreds of high tech products that were then -- he was writing in 1999 --driving not only Japan's export boom but the world technology revolution.

To be fair to Porter et al it has to be added that key members of the Tokyo foreign community had an agenda to mislead visiting Americans. It has always been so. As far back as the 1970s, Tokyo-based consultants were already describing the then utterly closed Japanese market as one of the world's most open. In the 1990s key analysts pitched in to support Japan's new "bad news" strategy. This may seem surprising but several of the key analysts in Tokyo have consistently shied away from invitations to debate their doom-and-gloom take on post-bubble Japan.

If there is a moral in Japan's hidden strengths it is this: it is past time Washington began to address the implosion of advanced American manufacturing. Any full consideration of the flaws in current policy is beyond the scope of this article but Washington could at least as a first step take a jack-hammer to Japan's closed markets.

In a chivalrous wish not to kick a man when he is down, American trade negotiators removed all pressure for Tokyo to open Japanese markets nearly a decade ago. Thus even Japan's rice market is still tightly closed -- and this despite the fact that the American press announced in banner headlines in 1993 that the market had supposedly been opened. (Database note: many of these reports seem to have been airbrushed from the permanent record.)

For American trade policy, the most outrageous failure has been the Japanese car market. Detroit's share in the Japanese market has sometimes fallen below 0.5 percent. Of course, Japan's trade lobbyists allege that Detroit does not make cars configured for Japan's drive-on-the-left roads. Actually this is blatant propaganda. The Detroit companies have never had any trouble serving Britain, the world's other major drive-on-the-left market. In any case, many Japanese car buyers prefer the steering wheel on the "wrong" side: in a country where imports tend to be egregiously expensive, this is a status symbol.

The ultimate smoking gun here is the plight of the Korean car industry. Its products have made inroads all over the world -- everywhere except Japan. While Japan has opened up in a token way to Korean electronics exports (Samsung in particular has become highly visible in Japan), Korean car-makers are still completely excluded. Thus their sales in Japan last year came to just 2,930 units -- less than 0.04 percent of Toyota's output.

If the Japanese car market is really so closed, why hasn't Detroit pressed harder for access? Up to the mid-1990s Detroit did try but since then it has given up. The reason is clear: Japan holds the whip hand. The Japanese corporate establishment is noted for the alacrity with which it retaliates against American corporations who make trouble for its trade policy. Detroit used to be relatively immune from such pressure. Not any more. The American car companies are now heavily dependent on Japan for key materials like special steels, precision components like air conditioning compressors, and, most of all, for such vital machine tools as painting robots and body presses. In a word they are a prime victim of Japan's chokepoint strategy. If they were to make more than a token effort to fight Japanese mercantilism now, they would face certain retaliation.

All this prompts a question: if America's largest manufacturing industry can't stand up to Japan anymore, which nation is really the basket case?