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ENVIRONMENTS OF ECONOMIC DEVELOPMENT, THE OPEN ECONOMY AND PUBLIC POLICY: THE CASE OF JAPAN SINCE 1945

by

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INTRODUCTION

A significant feature characterizing relations between the industrial non-communist countries in the post-World War II period is their increased economic interdependency. The nature of this economic interdependency is marked by the mobility of resources, mainly capital, merchandise, skills and technology on a worldwide scale. Edward Morse suggests that there exists today a qualitative interdependency between the nations of the non-communist trading community.[1]

As Morse uses the term it means that the economic goals of governments increasingly are dependent upon actions taken by public and private entities beyond the jurisdictional boundaries of state authorities. This notion of a qualitative interdependency suggests a different reference point by which to measure economic integration than that employed by Karl Deutsch and others. Deutsch measures interdependency by a quantitative standard. He employs, for example, a null model to measure the amount of deviation from what would be expected knowing only the share of exports and imports by each country. The deviation from what is to be expected is defined as the coefficient of relative acceptance (RA). The RAs range between -1.00, when no trade occurs, to zero, in which case

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[1] Edward L. Morse, "Transnational Economic Processes," in Transnational Relations and World Politics, ed. by Robert O. Keohane and Joseph S. Nye, Jr. (Cambridge, Massachusetts: Harvard University Press, 1972).

trade equals the amount expected by the null model, to any arbitrarily high value. An RA of 2.00, for example, would indicate actual trade 200 percent greater than the model expectations.[2]

Oran Young, in a recent article, suggests why Deutsch's transaction flow analysis is methodologically inadequate for determining interdependency.

> Deutsch's argument is based upon a rather narrow and selective range of indicators of interdependency in the world system. In most cases, his indicators deal with tangible and highly iterative transactions among nation-states such as the exchange of commodities or the flow of letters. Even in economic terms, this procedure de-emphasizes sharply a variety of factors leading to interdependency. It fails to account for the flow of managerial personnel and techniques, the working of the international monetary system, the impact of what Richard Cooper has called the 'increased sensitivity of foreign trade,' and so forth.[3]

In large measure this qualitative interdependence is the result of deliberate efforts to establish a worldwide

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[2] See, for example, Karl W. Deutsch and Alexander Eckstein, "National Industrialization and the Declining Share of the International Economic Sector, 1890-1959," World Politics, XIII (January, 1961), pp. 267-299; and "Population, Sovereignty, and the Share of Foreign Trade," Economic Development and Cultural Change, X (July, 1962), pp. 353-366; also Kenneth N. Waltz, "The Myth of National Interdependence," in The International Corporation: A Symposium, edited by Charles P. Kindleberger (Cambridge, Massachusetts: M.I.T. Press, 1970), pp. 205-223; and Hayward Alker, and Donald Puchala, "Trends in Economic Partnership: The North Atlantic Area, 1928-1963," in Quantitative International Politics: Insights and Evidence, edited by J. David Singer (New York: New York Free Press, 1968), pp. 291-293.

[3] Oran Young, "Interdependence in World Politics," International Journal, XXIV (Autumn, 1969), pp. 731-732. See also Richard Cooper, The Economics of Interdependence (New York: McGraw-Hill, 1968), Chapter 3.

commercial system based upon the principles of division of labor and comparative cost advantage. This approach to commercial interchange was influenced by the difficulties encountered during the interwar period, as nations separately sought to solve their economic problems. At that time economic difficulties led to what Ragnar Nurkse has called "beggar-my-neighbor" policies, wherein countries sought to maintain domestic full employment by drastically curtailing the importation of foreign-made products. When other nations responded in kind, and when the overall purchasing power in the trading system had been drastically reduced, the general level of welfare of all states in the system was proportionately reduced.[4]

In order to establish a pattern of commercial intercourse based upon systematic rules of commercial behavior, and minimize the possibility that the sequence of events which culminated in World War II would again arise, international economic machinery was created.

The International Monetary Fund and the General Agreement on Tariffs and Trade were established in the immediate postwar period. Later (1960) the Organization for Economic Cooperation and Development was established, which had grown out of its predecessor organization, the Organization

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[4] Ragnar Nurkse, Equilibrium and Growth in the World Economy (Cambridge, Massachusetts: Harvard University Press, 1961), p. 58.

for European Economic Cooperation. This latter organization was set up in the immediate postwar period to administer economic recovery aid granted to a number of European countries by the United States.

Together the basic objective which these three organizations strive to implement is the exchange of economic resources between nations according to the principles of comparative advantage and division of labor. This system, according to Raymond Vernon, "When operating benignly, stands for all the good things that can be achieved by open boundaries: more trade, more capital flows, more movement of ideas and people, more growth."[5]

In recognition of the fact that state authority can impede the functioning of the open kind of economic system described above, the IMF, GATT and OECD have established rules to which member nations must subscribe. Particularly with respect to the IMF and the GATT, the rules vary according to the economic status of the member nation. The area of permissible unilateral economic action of a prosperous nation is more circumscribed than that of a less prosperous member.

The following is a brief descriptive analysis of the basic regulations and principles to which the industrially advanced member nations of each organization agree to adhere.[6]

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[5] Raymond Vernon, "Sovereignty at Bay," Foreign Affairs, XLVII (October, 1968), p. 120.

[6] Note: Basic to this study is the distinction between economically advanced and economically developing nations. In this paper the distinction is based solely upon whether or not

International Monetary Fund

The broad purpose of the IMF is "to promote exchange stability, maintain orderly exchange arrangements with other members, and to avoid competitive exchange alterations" (Art. IV). Advanced fund members are also pledged to refrain from exercising controls over international capital movements "in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments" (Art. VIII). It should be noted that it is acceptance of Article VIII that the poorer nations find most difficult; for such acceptance means that a country cannot use exchange controls to curtail the inflow of goods and services on current account (transactions of one year or less). For this reason, most of the so-called developing states of the IMF are exempt from this requirement (Arts. XII-XIX).

General Agreement on Tariffs and Trade

The basic purposes of the GATT are: (1) To establish the principle that international trade should be conducted on a non-discriminatory basis; (2) to encourage countries to

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a member country of the organizations under study has agreed to refrain from imposing quantitative restrictions on almost all of its short-term trade, and agreed to keep to a minimum the number of restrictions it places on foreign investment. Herein no attempt is made to single out the critical variables of economic development in order to classify nations into advanced and less than advanced categories. For further explanation of the term "advanced," particularly as it relates to economic liberalization, see above and *infra*, pp. 19-20, footnote 27. Countries which fall under the label "advanced," as used herein, are all nations of Western Europe, including Greece, Turkey, Britain and Ireland, and the U.S., Canada, Japan, Australia and Iceland.

abide by the most favored nation principle in establishing tariffs against the importation of goods; and (3) to work toward the abolition of non-tariff barriers to trade, particularly quantitative restrictions, which, according to Khurshid Hyder, were considered inherently discriminatory in their application.

> The significance attached to the principle of nondiscrimination can be gauged from the fact that one of the many reasons for the decision to abolish quotas altogether was the lack of a satisfactory formula for their nondiscriminatory application. 7

As in the case of the IMF, developing countries are exempt from some of the limitations placed upon the more economically advanced states. The most significant exemptions are covered by Articles XII-XV, which permit quantitative restrictions when a country has a chronic balance of payments problem.

Organization for Economic Cooperation and Development

As spelled out in Article I of the OECD Convention, the primary goals of that organization are to promote economic growth, employment, a rising standard of living, financial stability, economic expansion, and trade among all nations.[8]

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[7] Khurshid Hyder, Equality of Treatment and Trade Discrimination in International Law (The Hague: Martinus Nijhoff, 1968), pp. 46-47.

[8] See Preface to "The Organization for Economic Cooperation and Development," The Industrial Policy of Japan (Paris: OECD, 1972).

As quantitative restrictions to the flow of merchandise on current account had been largely eliminated under the authority of the OEEC, the functions of the OECD, the organization which took over from the OEEC, were largely limited to two areas. The first had to do with freeing controls on current invisible transactions, and the second with easing controls on capital flows of a long-term nature. Accordingly, the Code of Liberalization of Current Invisible Operations and the Code of Liberalization of Capital Movements were established. Although the Invisible Code (current account transactions) does come under the restrictions imposed by Article VIII of the IMF, member countries have imposed so many reservations with regard to payment on the invisible account that re-enforcement of this proscription is deemed useful through the Invisible Operations Code.

Included in the Invisible Code are over fifty types of transactions which member countries have committed themselves to free from restrictions, subject in some cases to limiting provisos.[9] Examples of invisible transactions are payments for such things as shipping insurance, royalty and copyright payments, and motion picture importation.

The idea behind the Capital Movements Code is to curtail the number of restrictions imposed by governments on the flow of long-term investment capital into and out of a country. The long-term refers to a period of a year or more, and is

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[9] Donald Templeman, "Liberalization of Investments in the OECD," Journal of World Trade Law, VI (July-August, 1972), p. 427.

divided into direct and indirect investment, the latter being sometimes referred to as portfolio investment. Bo Sødersten distinguishes between the two types in the following way:

> The main distinction of direct investments is that the investor retains control over the invested capital. Direct investments and management go together. With portfolio investments, no such control is exercised. Here the investor lends his capital in order to get a return on it, but he has no control over the use of that capital. 10

Especially in connection with long-term capital flows, sanctions against impediments put in the way of such flows by member governments are not as comprehensive as those sanctions imposed by GATT and the IMF with respect to restrictions on current account transactions. Unlike under the GATT, no retaliatory action by a member nation is permitted when it feels it has been unjustly treated by another member. In the words of Donald Templeman:

> Neither does the Organization have the degree of leverage that is possible in the case of the International Monetary Fund, which is an important source of financing for countries which face balance-of-payments problems. 11

However, inside the OECD the country's action is not totally unrestrained. Pressure to conform to expected norms is the result, according to Kenneth Dam, of a "club atmosphere." And once a country has been admitted to the club it is "moral

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10 Bo Sødersten, International Economics (New York: Harper and Row, 1970), pp. 444-445.

11 Templeman, "Liberalization of Investments," p. 429.

suasion" or "collective pressure" which tends to limit a country's freedom of action.[12]

The element of "moral suasion," or what J.O.N. Perkins has called "multilateral surveillance"[13] through annual confrontation and critical discussion, is not absent in the IMF and GATT. But in the OECD, a much more economically and politically homogeneous and cohesive atmosphere prevails, promoting a situation in which the actions of members are often restrained by the desire to be accepted in the family of economically advanced countries.

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12 Kenneth W. Dam, The GATT: Law and International Economic Organization (Chicago and London: The University of Chicago Press, 1970), p. 387.

13 James Oliver Perkins, International Policy for the World Economy (New York: Praeger, 1969), p. 226.

Advanced Status Membership in the IMF, GATT and OECD, and Implications for the Nation-State

In the modern commercial system those countries which have accepted the norms of a relatively open and competitive system of economic intercourse, and have joined such organizations as the IMF, GATT and OECD to promote these objectives, experience a diminution of economic sovereignty. Georg Schwarzenberger stated that membership in such organizations means sacrificing authority in economic areas which traditionally has been considered to be "within the unfettered domestic jurisdiction of states."[14] This is bound to involve, Karl Lowenstein adds, "Intervention into the internal and external affairs of the states participating in the co-operative pattern."[15]

States are willing to impose such self-limitations upon themselves for several reasons, all of which relate to technological advances in the modern era. First of all science, as applied to the means of destruction, renders the national acquisition of prestige, wealth and power through force less feasible today. Particularly amongst the major

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[14] Georg Schwarzenberger, "The Province and Standards of International Economic Law," International Law Quarterly, II (Autumn, 1948), p. 411.

[15] Karl Lowenstein, "Sovereignty and International Co-operation," American Journal of International Law, XLVIII (1954), p. 238.

industrial powers, the balance of terror serves to render force an unlikely way for nations to pursue their goals. This modern day reality has prompted Klaus Knorr to state:

> The political and economic leaders of industrial and wealthy countries are now aware that domestic saving and investment and the advancement of education, science and technology are the most profitable means and the most secure avenues to the attainment of wealth and welfare. 16

However, attainment of these goals requires unprecedented levels of co-operation among the various states in the commercial system, if each state is to achieve its economic goals. Again this is attributable to advances in technology, this time as it affects the means of communication and transportation. The wealth of a nation depends upon the efficient use of its resources, and is facilitated if capital, commodities, services, and labor can be bought and sold in those markets where the greatest return on the investment can be obtained. From this perspective, then, national borders can function today more as an impediment than as an advantage to national well-being. Thus, to the extent that nations are prepared to cooperate to achieve their economic goals, they have institutionalized rules of commercial conduct which are administered through international organizations. This creates a dilemma for the relationship of the modern state to its environment, Karl Kaiser feels, for "highly

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16 Klaus Knorr, On Uses of Military Power in the Nuclear Age (Princeton: Princeton University Press, 1966), p. 22.

developed welfare states could only become masters in their own houses if they were to cut through the links with the outside world, but precisely the links have become the prerequisite for their economic welfare."[17]

To illustrate how traditional areas of national economic sovereignty are curtailed as a result of advanced status membership in the IMF, GATT, or OECD, several examples are presented below.

1. Acceptance of GATT prohibitions on the use of quantitative restrictions on current account transactions.

With quantitative restrictions largely prohibited, nations are compelled to protect domestic interests primarily through the use of tariffs and other forms of indirect devices, e.g. fiscal and monetary policies. These methods are much less certain of achieving the desired state objective, and usually require planning far in advance in order to have any substantial impact. Even tariffs may be unable to stem the flow of goods into a country under some circumstances. As one economist has pointed out,

> A country confronted with an inelastic supply of exports of certain goods would find it difficult to limit imports of the goods by way of a tariff. Under these circumstances, a tariff would primarily give the tariff-imposing country a large improvement in its terms of trade, but it would

[17] Karl Kaiser, "Britain and the Federal Republic in their Multinational Environment," in Britain and West Germany, ed. by Karl Kaiser and Roger Morgan (London: Oxford University Press, 1971), p. 34.

fail to protect domestic production of the goods by a limit of imports. 18

Thus, agreement to forsake the use of quotas means that various economic demand sectors, with potential political influence, yet very possibly representing inefficient sectors of the economy, are less certain today of having their economic interests protected through government action. Similarly government is constrained from acting in whatever way it wants to achieve economic goals it has declared as important. International commercial rules, then, have led to certain adjustments in domestic economic policies and practices and created new opportunities in the world market: "The only successful survivors are those who can innovate or adapt to a changing environment."[19]

2. Acceptance of OECD and IMF prohibitions on the use of exchange restrictions on current account transactions.

By subscribing to the rules of the IMF and/or the OECD, governments place themselves in the position where the flow of money into and out of a country is increasingly difficult to control. The actions of private societal forces today can determine, or at least influence, governmental goals. Using modern Britain as an example, Karl Kaiser has written that,

[18] Sødersten, International Economics, p. 367.

[19] Peter Kenen and Roger Lawrence, (ed.), Open Economy: Essays on International Trade and Finance (New York: Columbia University Press, 1968), p. 191.

> The activities of societal actors inside or outside Britain, e.g. in the form of speculation, exchange of currency, foreign investment - though in many cases undertaken outside the British political system affect the British government's decision-making in domestic and foreign policy. 20

Any non-communist government today may have its domestic policies thwarted as a result of the mobility of even short-term capital. The deflationary policies of a government, designed to combat the problems of an economy which has become overheated, may be negated or neutralized by the inflow of foreign currency, which is made available from the foreign money lending system. For example, in an article in Newsweek Magazine, it was reported that the Social-Democrat Government of Willy Brandt of the German Federal Republic was claiming that the inflationary trouble within the country was an "international phenomenon." It was stated that the 6 percent annual inflation rate was "imported" because of the country's "wide-open money market."[21] In the 1973 federal elections the Social-Democrats were barely returned to power, as the government was hard pressed to defend its economic schemes. If the party had lost control of the government entirely or partly because of its economic policies, the connection between the wide open operation of the international economic system and domestic political consequences would have been readily apparent.

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20 Kaiser, "Britain," p. 31.

21 "Brandt Serves Up a Waffle," Newsweek, January 29, 1973, p. 34.

3. <u>Acceptance of OECD principles which discourage the use of devices to impede the flow of long-term direct and indirect investment capital</u>.

The flow of foreign monies, frequently accompanied by technology and personnel, increasingly is finding its way into the investment structures of societies. This is accomplished through either direct or portfolio investment. Direct (equity) investment can have some influence on domestic structures in the host country. Although much research needs to be undertaken before it is possible to determine more precisely the impact the multilateral corporation has upon the internal policies of its host country, it does seem clear that it has modified the typical conception of the nation-state system. Its mode of operation, wherein it produces in those countries where labor is cheapest, imports capital from markets where it is most plentiful and least expensive, and sells in those markets where the return on its investment is greatest, has internationalized this corporate structure, and, in the process, rendered it less accountable to any single national political authority.

It is the power and influence wielded by such entities as the multinational corporation that has prompted John W. Burton to suggest that the typical government-to-government relationship (what he calls the "billiard ball" model) is today no longer an apt description of how the international system operates. He states:

> With this model in mind our attention is directed away from other relationships. How important are

> diplomats and governments in the scheme of things? To what extent is the making of policy the free decision of governments, and to what extent do governments reflect the needs and interests of others conducting their own transactions across state boundaries? 22

Isaiah Litvak and Christopher Maule refer to the friction that can arise between the multinational corporation and the host country, and between the parent and host governments, because of action taken by the multinational corporation.

> Each nation-state possesses a business environment which is characterized by certain economic, political, legal, and socio-cultural factors... The government of each nation-state, through its policy, will attempt to mold its environment to fulfill its national objectives, and where the two countries are completely isolated from each other, their national interests will not conflict. However, once both countries become a part of the international economy, the potentiality for conflict exists, because of the ties between the parent company and its subsidiary, such that the policies of one country tend to get transmitted to residents of another country...The probability for conflict is highest when the policies of the host and parent governments differ markedly... The nature of the multinational firm is such that the direction of policy transmission tends to be from the parent to the host country, and, thus, extra-territorial conflicts usually originate from entities in the parent country. 23

It should be apparent from the above that the freer flow of economic resources has brought into question traditional notions about the sovereign authority of national

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22 John W. Burton, World Society (Cambridge: Cambridge University Press, 1972), pp. 28-29.

23 Isaiah A Litvak and Christopher J. Maule, "The Issues of Direct Foreign Investment," in Foreign Investment: The Experience of the Host Countries, ed. by Isaiah A. Litvak and Christopher J. Maule (New York: Praeger Publishers, 1970), p. 8.

governments over domestic economic matters. But also the benefits that could be derived from the optimal allocation of the world's resources have not, and probably will not, ever reach their full potential. The political problems standing in the way of a more open world trading system will be discussed later; here, it need only be noted that the sovereignty of a national authority lessens once it joins the family of industrially developed non-communist nations. When a country does this, politically sensitive areas get exposed to the full range of pressures and influences which organizational members, acting both independently and collectively can bring to bear on another's policies. Raymond Vernon writes:

> Through institutions such as the International Monetary Fund, and the OECD there are still well-entrenched habits of international consultation and international persuasion on domestic subjects of the most sensitive sort: on internal interest rates, on budgetary and fiscal policy and on employment and incomes policy...A decent respect for the opinions of mankind now seems to require a willingness on the part of sovereigns to expose many critical national economic policies to the collective scrutiny of a jury of peers. 24

Political Authority of the Nation-State

Despite movement toward a more open and rule-bound international commercial system in the postwar period, the nation-state remains the ultimate repository of power. As

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24 Vernon, "Sovereignty," p. 110.