Japan is now the world's second greatest economic power. At current exchange rates its per capita income is higher than ours. It is moving to number one in many areas of advanced technology which we once dominated. The power of the yen is transforming Japan into a financial, as well as industrial, giant. The world's largest creditor, Japan finances a big chunk of the U.S. budget deficit and thereby helps lower interest rates in the U.S.

At the same time, its economic relations not only with the U.S. but with other countries are already the source of conflict. The Japanese trade surplus is the biggest in history. The great Pacific economic power—and one of our closest allies and friends—finds itself attacked in the U.S. Congress, in ASEAN, and by the EC. China and Korea complain. How this great industrial and financial powerhouse adjusts to this mounting criticism is of great importance to all of us.

In my view the two events of greatest importance to U.S.-Japan relations during the past year were the near 50 per cent appreciation of the yen and the overwhelming electoral victory of Prime Minister Nakasone's Liberal Democratic Party in the July general election. The former has brought a
reduction in the volume of Japan's exports and should in a few months result in improvement in the bilateral trade imbalance. It also has hastened the transformation of the Japanese economy.

The latter should be seen as a confirmation of the direction of Japanese policy--and of Japan's membership in the Western alliance--and a ringing endorsement of the Prime Minister.

The LDP victory was the result of several factors.

-- First, there is general satisfaction with the present state of affairs in Japan. Despite high prices and creeping unemployment, Japanese are living better than ever.

-- Second, the LDP is well-organized, its leadership highly talented, and its workers dedicated.

-- Third, organized labor's support for the socialist party was weakening faster than previously thought--largely assisted by the privatization of several public corporations.

-- Fourth, voters did not see the opposition as a credible alternative.

-- Most importantly the extraordinary popularity of the prime minister helped a number of voters decide in favor of the LDP. Although few in the party will admit it, Mr. Nakasone's personal popularity--at record levels for the past two years--was a major factor in the LDP victory.
Because the election result will assure continuity and stability—including the continuation in office for another year or more of the prime minister—it is good for U.S. interests. However, the LDP victory should not be viewed as a sign that the adjustment of our relations will be quicker, or that it will be any easier for Japan to undertake the reforms which are necessary. The increase in the LDP Lower House seats will more likely mean an increase in the influence of special interest groups which are resistant to change.

Nonetheless, Prime Minister Nakasone remains the strongest advocate of market opening and the "internationalization" of Japan. He is ahead of the mainstream of his party and of much of the bureaucracy. He has a greater appreciation for Japan's role and the impact Japan has on the world economy. We can count on him to continue the fight to enhance the free trade system, but we must realize that his power is restricted by the nature of the political system.

Nakasone is a complex individual. Before becoming prime minister he was widely regarded as a strong nationalist. He was viewed with suspicion by many for fear he would turn Japan dangerously to the right jeopardizing the progress toward genuinely representative institutions since the war. Many people worried that Nakasone would become a Japanese Gaullist
In reality, Mr. Nakasone turned out to be a pragmatist and a strong believer in the importance of a close U.S.-Japan relationship. While he has not discarded his agenda to restore national pride and revamp some postwar institutions, he has proven to be one of Japan's most broad-minded, internationalist prime ministers. He has worked hard at diplomatic tasks—the special "Ron-Yasu" relationship is genuine.

Mr. Nakasone is likely to remain in office through next year's ordinary Diet session—May or June. After that, it's anybody's guess. He might step down while he is still on a roll. Or, he might stay in office until the end of 1988. I don't know who will take his place. The odds change on the three "new leaders" almost weekly. While Mr. Nakasone has been very helpful to us, all three new leaders are moderate, experienced statesmen who believe that Japan cannot exist without the closest relationship with the United States; they have built their careers on this belief. We know all three. As far as U.S. interests are concerned, the change of leadership, when it comes, will be one of style, not substance.

While some Japanese are becoming irritated with Congress' verbal attacks and with wave after wave of trade negotiators taking up increasingly sensitive issues, most of the
establishment is aware that Japan cannot avoid taking actions to preserve the free market trading system. Most understand that whether foreign accusations of protectionist practices are right or wrong, Japan's $60 billion surplus with the rest of the world could lead to disaster for Japan and for the whole trading system if doors close for Japanese products. Many outsiders consider the Japanese insular or even arrogant—I do not—but most Japanese are aware that they live in an interdependent world.

In the past 40 years Japan's foreign policy has been low key but, effective. Japan has recently become more active. Of particular note has been an expanded dialogue with the Soviet Union which will probably lead to a summit early next year. Gorbachev's more flexible diplomacy puts some pressure on Japan to respond and Mr. Nakasone has a sense of history that will draw him toward the first summit between a Japanese prime minister and a Soviet leader in more than 15 years. There is little inclination, however, in any party or in the government to compromise on the main issue: return of the Northern Territories. Without a territorial concession by the Soviets, progress is unlikely. In contrast to the 1970s when energy was expensive and Japan looked to the Soviet Union as a growth market, there is now a surplus of most commodities Japan
needs. And, the Japanese are wary of Soviet interest in high technology. Thus, while a summit will probably take place, the results are likely to be cosmetic rather than substantive.

Japan has continued to develop its relations with China and Korea, successfully overcoming the setbacks that resulted from the textbook problem and ill-conceived remarks by former Education Minister Fujio. Mr. Nakasone's visit to the opening of the Asian games in Seoul represents his laudable commitment to stabilizing Japan-ROK relations. His visit to China next month should further improve relations as well as send a signal to the Soviets that he intends to pursue relations with both continental neighbors.

We are working very closely with the Japanese in the Philippines. The GOJ has been supportive of the Aquino government--Mrs. Aquino will visit Japan November 10-13--at that time the GOJ is expected to announce additional financial assistance, although probably less than the 100 billion yen requested.

In other areas, Japan has continued to urge moves toward peace on Iraq and Iran--drawing on its diplomatic relations with Baghdad and Teheran. Japan recently toughened its economic sanctions against South Africa, working closely with the EC. Japan continues to support us in the Caribbean, and in
Central and Latin America.

Our security relations with Japan have never been better. This summer we saw the GOJ decide to participate in SDI; agree to permit ROK-based U.S. aircraft to participate in U.S.-Japan exercises; successful port calls by the first-ever Tomahawk-capable U.S. Navy ships to visit Japan, including the New Jersey; the first two defense technology transfers from Japan to the U.S.; and a highly productive U.S. visit by Defense Minister Kurihara.

During the year we conducted more than twenty joint exercises, each resulting in even closer coordination and valuable lessons for future planning and procurement. The Japanese government is spending more than $1.0 billion annually in support of U.S. forces in Japan and public support for the security relationship has never been higher.

We expect Japan to fund fully its current five year plan. The decrease in the value of the dollar has helped Japanese budget planners insofar as petroleum and U.S. weapons systems are cheaper, but it has had the opposite effect on us. We are working with U.S. Forces Japan to develop ways in which the Japanese government can increase its contribution to our operations.

Japan took an important step last winter regarding our
earlier INF proposal. For the first time the Japanese forcefully made suggestions on a strategic issue. The Japanese appreciate the differences between Soviet SS-20s in Europe and in Asia, but reductions in Europe without some equivalent agreement on Asian SS-20s would suggest that the U.S. and Europeans were neglecting Japan's basic security needs. The Japanese are also faced with another set of problems--separate treatment for Asian SS-20s runs the risk of giving the Soviets an opportunity to equate their INF deployments with our deployments in the Pacific and to link reductions in U.S. access to Japanese facilities to further reductions in Asian SS-20s. Such a discussion would put needless strain on public support for U.S.-Japan defense cooperation.

Japan's important decision to participate in SDI reflected a desire not to be left behind if new technologies are developed, but the most important consideration, was the prime minister's desire to demonstrate Japan's solidarity as a member of the Western alliance.

Looking to the future means examining Japan's surge into super power economic status. The appreciated yen is having a series of important effects which go far beyond the U.S.-Japan trade dimension:

-- As the yen climbs, it transforms Japan into a great
world financial power; the world's biggest securities firm is Japanese, as is the world's largest bank—and six of the top ten banks are Japanese.

-- Structural changes, yen appreciation, and competition from the NICs, are pushing Japan away from low and middle tech industry and accelerating the move toward advanced technology—robotics, new materials such as ceramics, biotechnology and advanced electronics.

--Japan is expanding its foreign investments at an astonishing rate; it is now the world's largest creditor nation; direct investment in the U.S. exceeds $25 billion, and is skyrocketing. Portfolio investment in the U.S. will probably exceed $50 billion this year.

--The strong yen is forcing Japanese industry to source abroad and to move its lower-technology industry abroad.

But, despite the outcries of the industries caught by the upward surge of the yen, farsighted Japanese welcome the financial strength that it brings, and the structural changes which it is forcing upon the economy and society. Ironically, the cumulative effect of structural economic changes in Japan and the appreciation of the yen may well be to shake out the least competitive companies, leaving the world with even stiffer Japanese competition.
All of this will have a powerful effect on Japan's relations with its Asian neighbors and with us. The combination of great financial power, cutting edge technology and strong international companies will make Japan a force to be envied, wooed and feared by its neighbors.

We often observe that Japan is an insular nation historically, preoccupied with its own affairs and disinclined to international leadership or even to international systems maintenance. Japan is changing, but will it, can it, change as rapidly as its economic and financial power is increasing? Will Japan assume a position of responsibility which corresponds to its new status as an economic superpower?

There is no simple, easy answer. Indeed, it is in part what the international community, mostly the U.S., will do that will bring forth the Japanese response. We need to do the following:

--Keep hammering away at market access, the opening of the Japanese economy to the U.S. and to all its trading partners;

--Maintain pressure for better and more responsible international economic behavior: capital market liberalization, reorientation toward domestic demand-driven growth, moderation of predatory corporate practices;

--Consult with Japan as an equal partner on international
trade, monetary and investment issues, and continue to encourage Japan to expand and deepen its role in the IBRD, the IMF, the GATT, the OECD and the international development banks;

--Remind Japan of its responsibilities toward the developing countries, and in particular those of ASEAN, regarding import volumes and composition, levels and composition of economic assistance, direct investments and technology transfer, all difficult issues for outsiders to influence.

At the same time, we have a challenging agenda at home:

-- To reduce rapidly our huge budget deficit;

-- To build a less adversarial relationship between labor and management, management and government;

-- To increase productivity, competitiveness, style of our products and to make much more vigorous efforts to export these quality goods;

-- For our businessmen, to take a hard look at short-sighted business practices and construct strategies for market growth;

If Japan and the United States have the will to carry through on these agendas, we can be confident of our future, of our relationship with Japan and of our role in the forthcoming century of the Pacific.
Japan is now the world's second greatest economic power. At current exchange rates its per capita income is higher than ours. It is moving to number one in many areas of advanced technology which we once dominated. The power of the yen is transforming Japan into a financial, as well as industrial, giant. The world's largest creditor, Japan finances a big chunk of the U.S. budget deficit and thereby helps lower interest rates in the U.S.

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-- Third, organized labor's support for the socialist party was weakening at a faster pace than previously thought--largely assisted by the privatization of a number of public corporations.

-- Fourth, voters did not see the opposition as a credible alternative.

-- Most importantly, in my view, the extraordinary
popularity of the prime minister helped a number of voters make up their minds in favor of the LDP. Although few in the party will admit it, Mr. Nakasone's personal popularity--at record levels for the past two years--was a major factor in the overwhelming LDP victory.

Because the election result will assure continuity and stability--including the continuation in office for another year or more of the prime minister--it is good for U.S. interests. However, the LDP victory should not be viewed as a sign that the adjustment of our relations will proceed more quickly, or that it will be any easier for Japan to undertake the macro-economic and structural reforms which are necessary. It is more likely that the increase in the LDP Lower House seats will mean an increase in the influence of special interest groups which tend to obstruct moves for economic adjustment and change.

Nonetheless, Prime Minister Nakasone remains the strongest advocate of market opening and the "internationalization" of Japan. He is way ahead of the mainstream of his party and of much of the bureaucracy. He has a greater appreciation for Japan's role in the world, and the impact Japan has had on the world economy in the past twenty years, and the impact it will continue to have. We can count on him to continue the fight to
enhance the free trade system, but we must realize that his power is restricted by the nature of the political system.

At the same time, however, Nakasone is a complex individual. Before becoming prime minister he was widely regarded as a strong nationalist. He was viewed with suspicion by many in the media that he would turn Japan dangerously to the right if given the opportunity and jeopardize the progress toward genuinely representative institutions since the war. There were many people who were worried that Nakasone would become a Japanese Gaullist and carve out a Japanese role at our expense.

In reality, Mr. Nakasone turned out to be a pragmatist and a strong believer in the importance of a close U.S.-Japan relationship. While he has not discarded his agenda to restore national pride and revamp some postwar institutions, he has proven to be one of the most broad-minded, internationalist prime ministers in recent memory. He has worked hard at diplomatic tasks—the special "Ron-Yasu" relationship is genuine.

Mr. Nakasone is likely to remain in office through next year's ordinary Diet session—May or June. After that, it's anybody's guess. There are some who advocate that he step down while he is still on a roll. Others feel he might stay in
office until the end of 1988. I don't know who will take his place. The odds change on the three "new leaders" almost weekly. It is important to note, however, that while Mr. Nakasone has been very helpful to us, all three new leaders are moderate, experienced statesmen who believe that Japan cannot exist without the closest relationship with the United States; they have built their careers on this belief. Furthermore, we have worked closely with all three. As far as U.S. interests are concerned, the change of leadership, when it comes, will be one of style, not substance.

Thus far, I am confident that, while some Japanese are becoming irritated with Congress' verbal attacks and with wave after wave of trade negotiators taking up increasingly sensitive issues, most of the leadership--and the media--is fully aware that Japan cannot afford to avoid taking actions to preserve the free market trading system. Most understand that whether foreign accusations of protectionist practices are right or wrong, Japan's $60 billion surplus with the rest of the world could lead to disaster not only for Japan but for the whole trading system if doors started to close for Japanese products. Many outsiders consider the Japanese insular, condescending or even arrogant--I do not--but most Japanese are aware that they live in an interdependent world and that they
must adjust to keep from being isolated.

In the past 40 years Japan's pursuit of its foreign policy goals has been quiet and low key but, on the whole, effective. During the past year Japan has become more active. Of particular note has been an expanded dialogue with the Soviet Union which will probably lead to a summit early next year. Gorbachev's more flexible diplomacy has put some pressure on the Japanese government to make concessions and Mr. Nakasone has a sense of history that will draw him toward the first summit between a Japanese prime minister and a Soviet leader in more than 15 years. There is little inclination, however, in any party or in the government to compromise on what for the Japanese is the main issue: return of the Northern Territories. Without a territorial concession by the Soviets, there is little likelihood that much progress will be made. In any event, in contrast to the 1970s when energy was expensive and Japan looked to the Soviet Union as a growth market, there is now a worldwide surplus of most things Japan needs. And, the Japanese are becoming increasingly wary of Soviet interest in high technology. Thus, while a summit will probably take place, the results are likely to be cosmetic rather than substantive.

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One area where we are working very closely with the Japanese is in the Philippines. The GOJ has been supportive of the Aquino government and Mrs. Aquino will visit Japan November 10-13. At that time the GOJ is expected to announce additional financial assistance for the Philippines, although probably less than the 100 billion yen requested.

In other areas, Japan has continued to urge moves toward peace on Iraq and Iran—drawing on its diplomatic relations with Baghdad and Teheran. Japan recently toughened its economic sanctions against South Africa, working closely with the EC, and in doing so displayed an awareness of its international responsibilities. Japan continues to support us in the Caribbean, and in Central and Latin America.

Our security relations with Japan have never been better. This summer alone we saw the GOJ decide to participate in SDI;
agree to permit ROK-based U.S. aircraft to participate in U.S.-Japan exercises; successful port calls by the first-ever Tomahawk-capable U.S. Navy ships to visit Japan, including the New Jersey; completion of the first two defense technology transfers from Japan to the U.S.; and a highly productive U.S. visit by Defense Minister Kurihara.

During the year we conducted more than twenty joint exercises, each resulting in even closer coordination between our forces and valuable lessons for future planning and procurement. The Japanese government is spending more than $1.0 billion annually in support of U.S. forces in Japan and public support for the security relationship has never been higher. I am also happy to report that community relations are at an all time high.

We expect Japan to fund fully its current five year plan. The decrease in the value of the dollar has helped Japanese budget planners insofar as petroleum and U.S. weapons systems are cheaper, but it has had the opposite effect on us. We are working with U.S. Forces Japan to develop ways in which the Japanese government can increase its contribution to our operations in accordance with the SOFA and earlier understandings.

Japan took an important step last winter when it made some
suggestions regarding our earlier INF proposal. For the first time the Japanese came to us on a strategic issue and stated their case forcefully. The Japanese appreciate the differences between the role of the Soviet SS-20s in Europe and those in Asia, but for us to agree on reductions in Europe without some equivalent agreement on the Asian SS-20s would make it appear that the U.S. and Europeans were neglecting Japan's basic security needs. In addition, the Japanese are faced with another set of problems--separate treatment for Asian SS-20s runs the risk of giving the Soviets an opportunity to equate their INF deployments with our deployments in the Pacific region and to insist on reductions in U.S. access to Japanese facilities before further reductions in Asian SS-20s. This kind of discussion would put needless strain on public support for U.S.-Japan defense cooperation.

Japan also took an important step when it made the decision to participate in SDI. Although the decision included a desire not to be left behind if new technologies are developed, the most important consideration, was the prime minister's desire to demonstrate Japan's solidarity as a member of the Western alliance.

Looking to the future means examining Japan's surge into super power economic status. The appreciated yen is having a
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We often observe that Japan is an insular nation, that it has, over its history tended to be inwardly turned, preoccupied with its own affairs and disinclined to international leadership or even to international systems maintenance. Japan is changing, but will it, can it, change as rapidly as its economic and financial power is increasing? In other words, will Japan assume a position of responsibility which corresponds to its new status as an economic superpower?

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If Japan and the United States have the will to carry through on these agendas, we can be confident of our future, of our relationship with Japan and of our role in the forthcoming century of the Pacific.