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RELATIONS BETWEEN THE EUROPEAN COMMUNITY AND JAPAN

The relations between the European Community and Japan are of ever increasing importance not only to each partner but also to the rest of the world. These relations have in the past been rudimentary and flawed by trade friction. Today, while trade problems remain, the relationship has become more substantial and more broadly based, and seems likely in future to undergo further enlargement and intensification. While the auguries seem good, however, and there is reason for optimism, this is no time for complacency. Much yet remains to be done if a closer and more collaborative future is to be assured and renewed friction and difficulty avoided.

There is little question these days that the fortunes of the economies of the Western world are liable to be very much swayed by the interactions of its three strongest economic powers, the United States, the European Community and Japan. These three, through their commitment to democratic principles, their political stability and their economic strength also exercise a significant political influence in the world.

Both Japan and the Community have devoted effort and invested political capital into strengthening their side of this triangle. But the bilateral relationship is also a problematical one. Partly because it is still very much in evolution (as compared to the now mature, well-established relationship between the Community and the US). Partly, however, because it is marked by a number of rather fundamental snags. These show themselves most visibly in the Community's considerable structural trade deficit with Japan. But this is in reality only the outward and visible sign of a deeper problem, not about bilateral trade deficits as such, but about the pace of Japan's integration into the multilateral system as a whole, and the extent to which Japan is considered to have assumed her fair share of the burden of responsibility for that system's maintenance. Clear vision is not easy here. The waters tend to be somewhat muddied. There is a conflict of images, and also of myths. A certain amount of demythologising is thus called for.

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In a still evolving relationship, much remains to play for, and one cannot always be certain what the end result will be. Different commentators, however well informed, discover in their crystal balls quite different pictures of the future. At one extreme we have the "nightmare scenario". At the other we have the "happy ending hypothesis". As I shall later declare, I perceive what might be described as a qualified "soft landing".

Why is the EC/Japan relationship so inherently important? Paradoxically, we are some way from being each other's major trading partner. Japan accounts for less than 5% of the Community's two-way trade, and the Community for less than 10% of Japan's. We are situated on opposite sides of the world, without cultural or linguistic similitudes and only a recent and patchy common history. Although friendly democracies, we are not formally partners in any military or strategic alliance.

What qualifies and indeed compensates all this has been the fact of Japan's accession to world economic rank. In that capacity Japan has become important both bilaterally and for her wider role in the international economic and financial system. From being a "3% country" 25 years ago in terms of her share of world GNP, with a GNP then 5% that of the US, Japan has become a "10% country" in global terms, with a GNP 35% that of America. The US, the EC Ten and Japan now account together for over 50% of world GNP and of world trade, and thus willy nilly they jointly bear the lion's share of the responsibility for the health and welfare of the system.

It follows from this that Japan now shares with the Community a wide range of common interests and responsibilities.

As part of the "triangle" with the US, both are firmly committed to the maintenance of the multilateral free trade system. Both were important actors in the last round of multilateral trade negotiations, and will be even more so in the next. Both are fully paid up members of all the relevant clubs: the GATT, OECD, IMF, World Bank, UN, Western Economic Summit.

Again, Japan and the Community have in common their respective economic vulnerabilities. Both are essentially "workshops", using their craftsmanship and technology to create sophisticated products from basic raw materials, for which each is largely dependent on overseas sources of supply. The vast majority of their requirements of industrial minerals, and about half their requirements of wood and paper, are imported. Japan imports over 80% of its energy requirements. The Community, despite its rather more substantial indigenous reserves of oil, coal and gas, still has to import over 40%. Stability in other corners of the globe is of vital importance to both.

Politically, both are part of what we each see as "the West". Japan and the Community practise democratic forms of government. They share a number of interests and assumptions in foreign policy. Being located at opposite ends of the USSR, their fundamental strategic preoccupations are similar, and indeed interconnected.

/It follows that

It follows that each has - or should have - a deep and vested interest in the other's welfare. Europeans want to see a strong and stable Japan. And, as the Japanese Foreign Minister commented recently, "a strong, united and prosperous Europe is needed by Japan too". Or as Prime Minister Nakasone has observed: "security is indivisible".

As indicated earlier, the EC/US relationship is firmly established. So, for rather different reasons, is the US/Japan relationship. What we have seen more recently is an attempt to strengthen the third side of the triangle, by working on the "missing link" of the EC/Japan relationship.

How have Japan and the Community gone about this? What is the current state of play? What are the future prospects?

At the institutional level, a useful dialogue has existed for some time. Japan was one of the first countries to enter into diplomatic relations with the Community through an accredited Ambassador in Brussels. The Commission's own Delegation in Tokyo, opened in 1974, was one of its first bilateral diplomatic missions overseas. For 12 years now, twice-yearly talks have been held at top official level - the so-called "High Level Consultations". In 1984, a ministerial "round table" discussion was inaugurated in Brussels between a group of key Japanese Ministers and their Commission counterparts. Ad hoc ministerial visits in both directions take place with increasing frequency. There are also regular contacts on foreign policy matters within the framework of what we call European Political Cooperation.

On substance, the Community's dialogue with Japan has developed less satisfactorily. It has tended to be dominated by our trade deficit, which grew steadily from \$0.5 billion in 1970 to around \$12 billion in 1983. Japan has now for some time sold three times as much to the Community as we sell back to Japan. On the one hand, the Community has found it as difficult as any of Japan's other industrial partners to expand sales on the Japanese market. On the other, Japan has increasingly penetrated the Community market in a limited but growing number of key manufacturing sectors. What began with steel and shipbuilding, and then passed on to motorcars and consumer electronics, has today reached machine tools and office equipment. This process could well continue.

The Community's present policy towards Japan is essentially threefold:

First, we seek the further opening up of the Japanese market. We press the authorities not only to remove administrative barriers to imports, but also actively to encourage imports, particularly of manufactured goods. In parallel, we are pursuing various export promotion programmes. These aim at familiarising European business executives with the Japanese way of life, and methods of doing business. In this way, we hope to make it more attractive for European industries to commit themselves more actively to this market, and in some cases to throw aside an unwarranted "phobia" of Japan. Japanese business is not an invincible economic machine, despite the myth around it which some people find it convenient to keep up.

/Second, we

Second, we have invited the Japanese temporarily to exercise moderation in their exports to the Community in certain sensitive sectors, such as consumer electronics, machine tools and motor cars. The purpose of this is not to shelter inefficient European industries from the healthy rigours of normal competition. Since the Community, like Japan, has to export to survive, we have to meet Japanese competition in any event on third country markets. And the Community has no interest in encouraging protectionism. What we do want to avoid in present circumstances is sudden disruptive surges in Japanese exports to the Community, aimed at narrow product sectors.

Third, we seek to widen the interpenetration of the Japanese and European economies by fostering cooperation. This includes industrial cooperation, particularly by substantially increased levels of direct investment on both sides; collaboration in the field of science and technology and, finally, cooperation through joint projects in the area of development aid.

In regard to market opening, there has been an encouraging, if still incomplete, response. Various import barriers and over-complicated import procedures were reduced or simplified through negotiation in the 1970s. Since July 1981, when the Japanese Government first announced a policy of actively encouraging more imports, there has been a series of market opening "packages", the first in January 1982 and the fifth and most recent in April this year. A sixth package may now be in the offing, to meet criticism directed against Japan by her Asian neighbours. The Japanese Prime Minister, Mr Nakasone, has put his personal authority behind these various recent moves which are of considerable significance for the future.

The practical impact so far has not yet proved as great as had been hoped, for two reasons. One relates to certain specificities of the Japanese economy, to which I shall turn in a moment. A second probably resides in the fact that Japan has a developed and efficient bureaucracy, accustomed to taking responsibility for large areas of economic decision-making and regulatory activity, traditionally the fief of the Administration rather than of the Government itself. The cult of "Yes Minister" exists in Japan as in Europe, and major changes of direction in matters of this sort are in any case not brought about overnight.

But why does the Community worry so much over its trade deficit with Japan? Here we find ourselves once again in the realm of paradox. After all, we live in a multilateral, not a bilateral, trading system. We have large deficits with other trading partners (for example we ran until last year a trade deficit of similar magnitude with the US without getting particularly hot under the collar about it). And since we have big surplusses with yet other partners, does it not all amount to a question of swings and roundabouts? Part of the reason, once again, with Japan is that the deficit is a symptom of a more fundamental issue concerning the role of Japan in the international system and her degree of integration therein.

There is today, I suspect, a fairly widespread feeling among Japan's trading partners that she could do more to shoulder the obligations which are now the inescapable corollary of her achievements.

/An extreme version

An extreme version of this view was expressed in a book published last year by an American scholar, in which the chapter on "Japan and the World" begins with the proposition that Japan "has become an economic superpower but has refused to take an active part in running the affairs of an increasingly complex and fragmented world ... Japan has been content quietly to amass wealth and has watched from the wings as other powers jostled each other for center stage". If this was true of the past, it is happily no longer true today. Justice needs to be done to Japan's present political leadership. Mr Gaston Thorn, President of the European Commission, for his part said in Tokyo this year during his official visit, "Greatness always brings servitude. Success carries with it its own responsibilities". But Mr Thorn expressed confidence in Prime Minister Nakasone and his Cabinet colleagues to do what was reasonably within their power to assert the leadership which the world expects from modern Japan.

You may ask what all this really means. Take first the multilateral trading system. It draws its strength essentially from the tremendous expansion of trade in manufactured goods which has taken place since the Second World War. Nations have always bought the raw materials and agricultural products they needed to supply their industries and feed their peoples. The predominant characteristic of the post-war multilateral system has been the marked growth in intra-industry trade between nations. You buy my Fiats and I buy your Volkswagens. The Community, which is the world's largest producer of passenger motor vehicles, is also the world's largest importer.

Japan was not a founder-member of this system, and for a long time after joining it, she was still protecting what she saw as the infant industries of her post-war reconstruction; and was developing (for what were then perhaps understandable reasons) an autarchic, self-sufficient structure wherever possible. Her participation in the system therefore tended from the outset to assume a one-way trading profile, at least for manufactured goods. Only recently, the European Business Council in Tokyo, which represents the 1.100 European companies operating in Japan, noted that manufactured imports, as a percentage of total imports, dropped from just under 30% in 1970 to about 23% in 1982. In 1983 this figure rose to 25% and was nearly 28% in the second quarter of 1984. But in the Community the corresponding figure has always been in the region of 40% and the same is true of the US. Put another way, Japan's manufactures as a percentage of GDP have remained stagnant at around 2.5%, whereas since 1960 manufactured imports have risen from 3.3% to 5.7% of GDP for the Community, and for further comparison, from 2% to 5% for the US. Given Japan's particular factor endowment, some difference is of course to be expected. But the gap has led, rightly or wrongly, to the accusation that Japan is simply importing too little for the good of the system from which she herself derives such advantage. Big sellers, as my Vice President, Mr Haferkamp, has said in this context, should be big buyers too.

Then, the world monetary system, where it is paradoxical that the Yen should play only a minor role, despite the importance of Japan in world trade (4% of official world currency reserves, as against 71% for the US\$ and 16% for European currencies, led by the Deutsche Mark).

... the world economy. At present, economic recovery remains fairly patchy, the two bright spots being the US (at least until now) and Japan. The US has exported growth to its partners by means of its large trade deficit. The surge in US imports has helped to boost production in countries where growth has been slacker. Admittedly the interest rate policy pursued by the US authorities may have had a negative effect on growth elsewhere, and criticism has been levelled against them on this score. Japan, on the other hand, although enjoying increased substantial economic growth, has not always linked this to increased demand for manufactured imports from its trading partners. In fact, following the oil shocks of 1973/74 and 1978/79, Japan relied on export-led growth policies to lead her economy out of consequent difficulties and support a subsequently self-sustained economic expansion. In 1982 and 1983, this pattern was repeated.

Or take development assistance. Japan is a member of the OECD's Development Aid Committee, the main "club" of Western aid donors. A five-year plan has been announced, and warmly welcomed, to double aid between 1981 and 1985. At present, however, for understandable reasons connected with government budget deficits, Japanese aid is running at 0.33% of GNP, while the figure for the Community is 0.51%. Japan accounts for 75 of World Bank subscriptions and 5.6% of IMF reserves. The Community figures are 28.3% and 24.6%.

In 1983, Japan imported \$6 billion-worth of manufactured goods from the third world, while the Community imported over \$20 billion. With the six most heavily indebted NICs, both the US and the Community run substantial annual trade deficits. (The Community's stands at \$5.6 billion, the US's - mainly with neighbouring Mexico - is larger still.) Japan, by contrast, runs a modest trade surplus with those countries as a whole.

Leaving aside now this question of rights and obligations and international burden-sharing, it may prove helpful to look more closely at the Japanese economic and social system.

There is no question here of Japan's partners seeking any fundamental change in that system. In a sense, this is a sovereign matter which is not the direct concern even of friendly outsiders.

Let me also readily admit at the outset that we in Europe need to learn new lessons, and also re-learn from modern Japan certain old lessons which we once knew but have possibly since forgotten. We should salute her commercial and technological success. We cannot always imitate Japan, or incorporate her methods and values into our own industrial and commercial structure. But we can give credit where it is due, and generally strive to be fair and open-minded. Japan's technology, her manufacturing and management skills should serve as an example in certain respects, as well as a healthy challenge to our own people and ideas.

Let me nevertheless point to a number of specificities of the Japanese economic system which tend to cause difficulties. These features are of course undergoing change. But unless convergence is further pursued, they are not as they stand always very readily compatible with the systems managed by Japan's main trading partners in the OECD. *Hinc illae lacrimae.*

First, there seems to exist in Japan some degree of imperviousness to manufactured imports. There is a historical background to this phenomenon. Ever since the Meiji restoration of the last century, Japan has progressively opened her doors to the world. But there have been periods of reversal and of retreat back into the collective shell. Such a time was the immediate post-war period. During the reconstruction phase, as noted earlier, Japan decided - may indeed have been compelled - to minimise her dependence on imported goods for which domestic substitutes could be produced. Today, after 20 years of a more liberal trade policy, these old Mercantilist reflexes have not entirely disappeared, despite the creditable reduction or relaxation of many of the most visible barriers, such as tariffs and other formal measures, as a result of successive rounds of multilateral negotiations in the GATT.

Beyond the obvious barriers, however, lies a complex world of administrative regulation and customs procedure. Until recently, the Japanese tendency had sometimes been to apply vigorously their own very specific standards and certification procedures, which were evolved in isolation from those generally accepted elsewhere. Non-tariff barriers to trade thereby arose that hindered the normal expansion of foreign imports (ranging from cars to cosmetics) by adding marketing delays and extra costs. To be fair, the Japanese authorities have recognised the difficulties such procedures caused, and have recently taken steps to make their certification system simpler and more transparent.

Second, the Japanese distribution system seems ill-adapted to the handling of foreign manufactures in any large volume. The system has troublesome characteristics. There is a high degree of linkage between production, distribution and financing, in "families" or groups of companies, which tend to create privileged chains of distribution from manufacturer to retailer. In certain sectors, a large percentage of the retail outlets are actually controlled by Japanese producers, to the exclusion of new-comers. In the field of domestic electrical appliances, more or less tied outlets are as high as 55%. In the field of consumer electronics, the position is little different. According to "Fortune" magazine, Matsushita alone controls 55,000 retail outlets, of which 27,000 sell their products only. Finally, the distribution system is highly fragmented and characterised by an astonishingly large number of small firms, both at the wholesale and the retail level. Most foreign manufacturers are consequently obliged either to go into the hassle of setting up their own distribution chains, or to place themselves in the hands of a sole importer, who may well prefer high margins, low turn-over, and the minimum effort necessary to assure sales. Some exporters to Japan have sought to circumvent this problem by selling direct to the independent sector of supermarkets and department stores, which are usually more willing to handle foreign merchandise. But the further expansion of this category of outlet is limited by the perceived public necessity to preserve the livelihood of small distributors.

The Japanese financial system shows similar inward-looking characteristics. The Yen has not yet taken off as an international investment currency. It tends to be insulated from the main

stream of the world financial system. As we have noted, it has only a small reserve currency role. It is little used as a denominating currency for trade. Only 35% of Japan's exports and 3% of its imports are denominated in its own currency, compared with an average of from 60% to 80% for export sales and from 30% to 50% for imports which is the more common proportion for other advanced currencies.

Japanese interest rates are low, both nominally and in real terms, compared with those of her major trading partners. This reflects partly the existence of direct controls and partly a lower rate of growth in domestic demand which, in combination with the high rate of savings, leads to a surplus of loanable funds. Low real interest rates have a beneficial effect on manufacturing costs. Moreover, in recent years some of the surplus of Japanese savings has been invested overseas, which has tended to have a downward impact on the Yen rate. This in turn helps to improve the competitiveness of Japanese exports.

Some degree of imperviousness appears also to prevail as regards overseas investment in Japanese manufacturing.

By any normal criteria of commercial risk, Japan must be one of the most attractive investment sites in the world, given its huge and growing economy, political and social stability and established infrastructure. Yet - and here we come upon yet another paradox - Japan remains virtually unexplored territory for the foreign investor. Foreign-owned companies account for only 3% of sales in Japan, compared with 20% in Western Europe. Total Community investment in manufacturing commerce and services in Japan is only around \$0.6 billion, less than one-tenth of the level of Japanese investment in the Community. Until recently the explanation for this has been the existence of various forms of official restriction which have put the potential investor at a disadvantage. But many of these restrictions have now been removed. What remains are essentially the cultural and psychological barriers. It is, for example, in practice difficult for foreigners to take over a Japanese concern, and to exercise independent control over its policy and operations thereafter.

Clear vision in this area - and here I digress for a moment from my main thread - is not facilitated by the mythology which has grown up over the years concerning Japan's rise to economic stardom. A certain amount of demythologising may be necessary. Let us address two myths which have achieved wide currency in recent times.

First, the notion that the Japanese have the most open market in the world, and that protectionism is something that only Europeans (and Americans) engage in. The figures show a different picture. True, Japan is a major importer. But the Community is an even larger one. Most of Japan's imports consist of raw materials and food products which Japan itself cannot supply from within its otherwise highly autarchic economic base. Japan imports less than half as many manufactured goods as a percentage of GDP than does Europe.

/I think we

I think we also have to ask ourselves whether protectionism can really be defined in the simple terms of tariff rates and quantitative restrictions? Would not a more complete appreciation of a country's attitude towards free trade have to take into account the degree to which the importing country is willing to allow the competing products of its trading partners to penetrate and stay in its own market and as a result allow the exporter to share in the importer's prosperity, for the betterment of the trading system as a whole?

Let us take the case of textiles and clothing, a sector where the Community is frequently accused of protectionism because it makes use of the safeguards provided for in the Multifibre Arrangement under the GATT. In 1983 the Community was importing about \$14 billion of textiles and clothing. Japan with nearly half the population imported \$2.4 billion. When it comes to imports from the most competitive exporters, we see that from Hong Kong, South Korea and the People's Republic of China, Japan in 1983 imported textiles and clothing to the tune of \$1.17 billion, whereas the Community took from these distant suppliers nearly \$3 billion's worth. In 1983 the Communities' textiles and clothing imports from the ASEAN members amounted to \$570 million whereas Japan imported only \$71 million. Japan has a surplus with developing countries as a whole for all textile products of about \$2 billion, whereas the Community has a \$4 billion deficit. It is obviously not only lack of competitiveness on the part of these suppliers that explains the phenomenon. They are somehow being kept at arms length.

Let us take a second myth. Glimpsed from afar the Japanese economy looks like a smooth-running engine that never misfires. There is a widespread belief that Japan is a highly competitive economy, at the forefront of technological progress, that has overtaken, or is about to overtake, the decadent European and American economies across the board.

It is certainly true that Japan is highly competitive in a number of important sectors. The staggering success story of the past decade has been Japan's rapid pre-eminence in electronics, whether in consumer products such as video recorders or in electronic components such as semi-conductors. These new industrial pathways have to be added to the more familiar Japanese motorcars, watches, cameras, oil tankers and heavy industrial equipment that have found a ready place in the market places of the industrial world. Competition and quality and plain good value have got Japan there, and good luck to her.

But Japan is not only a producer and exporter of electronic wizardry. Like other industrial nations, Japan has her problem areas too.

Foremost among these are the special category of so-called depressed industries, now covering 24 sectors and including petroleum and petro-chemicals, sugar refining, cotton and wool spinning, fertilizers. None of these industries has at present much hope of standing up to international competition, and all are effectively protected by one means or another. To take another example, leather goods and footwear are inefficient and costly. Imports are regulated by quotas. In the case of leather, the imposition of invisible quotas was condemned by a GATT enquiry panel earlier this year, which called for their abolition.

The financial services sector in Japan is subject to heavy governmental regimentation and control and is not notably open to much healthy outside competition. Direct insurance is protected, and dominated by a comfortable oligopoly of domestic insurers. Japanese bankers are currently busy expanding their operations in Europe and the US; in the UK, for example, they now account for over 20% of both total lending and total deposits. In Japan, however, foreign bankers still account for only 3% of total lending and less than 1% of total deposits. Europe obviously has an edge here, if it can be brought to bear in a balanced overall economic relationship of give and take.

Europe also remains far and away the world's leading exporter of capital equipment, such as machine tools, and is also pre-eminent in export markets in chemicals, pharmaceuticals, biotechnologies and telecommunications equipment. In space research and aircraft technologies, Europe has developed satellite hardware and a new generation of medium-range commercial aircraft, both successfully launched on world markets. The image of Europe as an "industrial museum", so often projected, simply does not fit. The era of high technology could indeed bring with it new competitive tensions between Japan and its industrial partners. Some disquieting signs have already developed. Towards the end of last year, MITI introduced proposals for a new law that would in effect remove copyright protection from computer software, including foreign software, in a manner that contravened international conventions in this field. The storm of protest that resulted happily led to a re-think. More recently, at a time when both the US and Europe (European Space Agency) were actively competing in Japan to sell satellite and launching systems, and when the Japanese Meteorological Agency had expressed interest in acquiring a weather satellite from Europe, the Japanese Science and Technology Agency announced its intention to develop a totally indigenous space technology, with arguments which included the allegation that all foreign systems were unreliable and could not be repaired because components were sealed in to protect company secrets.

The old go-it-alone instinct dies hard. The implication that where Japan makes something she doesn't import it, and that where she cannot at present make something she will endeavour to do so, simply does not sit with the system. I sincerely hope that wiser counsels will prevail to ensure that Japan does not yet again return to the autarchic reflexes of the past.

Let us now leave the present and its historic roots and turn to the future prospects for the relations between Japan and the European Community.

Given the complexities and uncertainties, this could at best be no more than intelligent guess work. At worst it would be no more than crystal-ball gazing. What I propose to do therefore is to look at two hypotheses at opposite ends of the spectrum. At the pessimistic end is the "nightmare scenario". At the optimistic end, the "happy ending". Although they will serve to illustrate the parameters of the problem, I do not myself believe in either of these hypotheses. But my own personal crystal ball reveals a cautiously optimistic scenario - what I would call the "qualified soft landing".

/Both the

Both the extreme scenarios start from the same present reality. Most observers agree that Japan remains, relatively speaking, well placed to support continued world recovery. Its public sector is small and its borrowing requirements still supportable at around 4% of GNP, particularly since there is no question of private investment being "crowded out" to feed the public purse. Inflation is moderate (less than 2%) and the balance of payments surplus on current account (over \$30 billion or nearly 3% of GNP) allows plenty of freedom of manoeuvre for stimulating domestic demand and using monetary tools to push up the value of the Yen.

In the hypothetical "nightmare scenario", Japanese macro-economic policy retreats into an obsession about the level of public debt, and formulates the resolve to insulate Japan to some extent from the international economic adjustment process which other countries are having to go through. Domestic demand is held back (directly in the public sector and indirectly by constraining household disposable income); interest rates are kept low by direct controls; this in turn both depresses the Yen and facilitates domestic industrial investment. At the same time, Japan takes full advantage of its membership of the liberal trading system to boost its already relatively strong growth rate by aggressively expanding its exports in those relatively narrow sectors where its economy is extremely productive.

These policies predictably lead to increased friction between Japan and its major trading partners. The Community's own trade deficit with Japan grows remorselessly. European exporters continue to be frustrated in their efforts to penetrate the Japanese market. Key sectors of European industry find themselves under now intolerable pressure from Japanese exports. European firms attempting to market new high technology products find the rug pulled out from under their feet by pre-emptive strikes on the part of Japanese exporters. Major sectors of the Community's population come to see their economic and professional existence as being threatened, especially as Japan's success often appears to occur precisely in those parts of our economy which are already most vulnerable. Against the background of consistently rising unemployment (already projected to reach 11.5% next year) and of marked disparities of economic performance in different regions of the Community, this build-up of social and economic resentment fuels a political backlash of an irrational but dangerous quality. Trades union and others representing the interests of workers in the industries concerned assert pressure on governments. In parliamentary democracies, such feelings cannot be ignored or discounted out of hand. Political leaders come under intolerable pressure to take radical action against what is perceived - or misperceived - as a Japanese threat. In the last resort, retaliatory action is taken against Japanese exports, in which the Community is not alone. Japan retaliates in her turn. This escalation of trade friction then produces a backlash in which Japanese leaders who want to see their country more fully integrated into the mainstream of the multilateral economic system are prevented from pursuing their courageous and constructive policies. Japan turns in on herself once again, in the pursuit of traditional values. I do not need to dwell on the strategic and wider political implications of such a scenario.

/The "happy

The "nappy ending" scenario has the same point of departure. But instead of insulating herself from the international economic adjustment process, Japan uses the headroom which her healthy economic situation allows to help lead the rest of the world out of recession by stimulating domestic demand, and doing everything else possible to bring about a genuine expansion of manufactured imports, while continuing to show consideration for the difficulties of her trading partners by exercising moderation in exports of those products which are particularly sensitive to them. At the same time, Japan pushes forward the process of progressively taking on international responsibilities commensurate with her economic weight, both financially and in terms of economic leadership. Aid to the third world is increased as are Japanese contributions to the IMF and the World Bank. Measures are introduced to stimulate imports from the third world and especially from the LLDCs. Japanese financial markets are liberalised, bringing Japanese interest rates more into line with prevailing international rates, and allowing the Yen to assume an importance in the international financial structure which corresponds to Japan's importance in world trade. Japanese inward manufacturing and value adding investment in the Community increases, creating new jobs, and contributing new technology and managerial skills to the European economy. This in turn leads to an influx of foreign investment into Japan, particularly in areas where cooperation between Japanese, European and American firms can be most fruitful. In the new spirit of mutual trust engendered by new Japanese laws to protect foreign patents, joint ventures become the norm. A major Japanese firm is taken over by a European multinational. Under the influx of European expertise, Japan's service industry becomes a net exporter, compensating for Japan's first ever global trade deficit for 21 years ... which is where we came in.

To return to today's realities, where does the way ahead really lie? I believe we shall have - barring unforeseen accidents - a "soft landing". Recent experience suggests the best hope lies in cooperation, not conflict; in the diplomacy of recognition and encounter, rather than of needless misunderstanding and friction; in the informed and frank confrontation of issues, not the confrontation of one partner with another. This is why both sides now put so much effort into developing the promising dialogue I described earlier on. And why cooperation (commercial, industrial, developmental, scientific and technological) is now beginning to make headway.

An important step ahead has been Japan's acceptance of the Community as such as her natural interlocuter on the many international economic issues where Europe is united. The Foreign Minister, Mr Abe, made Europe his first overseas visit after taking office, and expressed the view, after the inaugural EC-Japan Ministerial "Round Table", that EC-Japan relations had entered a new stage. President Thorn echoed this sentiment during his official talks in Tokyo earlier this year. The Deputy Foreign Minister and I reached the same conclusion in our "High level Consultations" in Brussels last month.

In terms of the quality of the dialogue and of personal relationships at all levels this is undoubtedly so. The challenge now is to draw the logical consequences from the complementarity and interdependence of the Community and the Japanese economies, and to achieve a fuller and more lasting integration of Japan into the multilateral system. It is a challenge which neither we, nor Japan, can afford to funk.