

**Fundamental Issues in the  
United States-Japan Economic Relations**

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**Working Paper No. 81**

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The Brookings Institution

December 1993

Prepared for the Japan Economic Seminar meeting at Columbia University, November 20, 1993.

**Working Paper Series  
Center on Japanese Economy and Business  
Graduate School of Business  
Columbia University  
December 1993**

This paper is quite different from the usual Japan Economic Seminar presentation. Rather than a piece of original research, this paper is a summary of personal views and reflections about the current status of the U.S.-Japan economic relationship. The purpose is to stimulate discussion at our seminar meeting about the relationship, somewhat in continuation of what transpired at the seminar's Washington meeting concerning Marcus Noland's paper. My motive is largely selfish; since I am heading to Tokyo in January to work as a special assistant to Ambassador Mondale on economic affairs, I am eager to listen to my colleagues in the seminar before departing.

If there is a theme or conclusion to the following pages, it is that economists need to be less purely academic in their approach to bilateral issues. Important problems do exist in the bilateral relationship; they are not all necessarily true economic problems, but neither are they simply "political" issues which economists tend to view with disdain. Dealing with these problems obviously requires tact and diplomacy, but they can be ignored only at the peril of seriously damaging the overall economic and strategic relationship. Especially now that the cold war is over, and economic aspects of the U.S.-Japan relationship are receiving relatively more attention than in the past, economists have a responsibility to be closely involved in considering the nature of the problems and their possible solutions.

The issues fall crudely into macroeconomic and microeconomic categories, although there is a fuzzy boundary between the two. Both sets of issues are important, and are considered separately below. In addition, the two nations face a wide ranging set of global and regional economic issues on which the two governments engage in discussions, some

cooperation, and some disagreement. These broader international issues are also a very important part of the relationship, but are not part of this paper.

### Macroeconomic Problems

Economic theory provides little guidance concerning macroeconomic balances. Nations that have a surplus of domestic savings over desired levels of domestic investment are net exporters of capital to the world; those with insufficient domestic savings to finance desired levels of investment are net importers of capital. Especially if the capital importers are developing countries that desire to escape from their relative poverty, the availability of foreign capital becomes a means of overcoming the limitations of their domestic savings base. But even among industrial nations, net flows from surplus to deficit countries presumably represent an efficient flow, with capital seeking higher expected rates of return. Why should anyone care, then, if the United States ends up as a capital importer and Japan a large net exporter?

This is the criticism generally raised by economists over the political use made of Japan's global current-account surpluses (or, worse yet, its bilateral trade surplus with the United States). The frequent political argument that Japan must liberalize its import markets *because* it has large surpluses is ludicrous from the standpoint of economic theory. The surpluses exist because of the working out of macroeconomic forces, and not because of the existence of import barriers; protectionist countries can have deficits, and open countries surpluses. How nations choose to behave domestically--in terms of incentives/disincentives for savings and investment, or the stance of monetary and fiscal policy--is their own business

under the regime of floating exchange rates begun in 1973.

If Japan has a society that prefers to save heavily, has a level of investment (as a mature industrial economy) that is lower than the desired level of savings, and a government very wary of fiscal deficits, that is presumably the concern of the Japanese and no one else. If macroeconomic conditions in the rest of the world are amenable, the net surplus savings end up flowing to the rest of the world in the form of a current-account surplus and offsetting net capital outflow, as has been the case for more than the past decade.

I believe that this standard view is somewhat flawed and naive for several reasons. In reality, both Japan and the United States have some reason to be concerned about their imbalances with the rest of the world, and even some reason to be concerned about the bilateral current-account or trade imbalance. From a U.S. perspective, the large current-account deficits that emerged in the 1980s (especially against a backdrop of Japanese global surpluses) were not necessarily benign. In essence, the current-account deficits were a symbol of the relatively poor overall performance of the economy over the past two decades. Slower economic growth, the drop in productivity improvement, the secular decline of the dollar against major currencies, are all part of the relatively weak performance of the U.S. economy in an international setting.

To the extent that this is true, American complaints about the bilateral trade imbalance or the global imbalances are really self criticism. The Japanese fear that they are being made the scapegoat for American problems, but, in fact, most thoughtful officials and politicians in Washington are well aware that solution to this problem is largely domestic. Eleanor Hadley pointed out many of these domestic sources of American problems with Japan back in 1979,

in a GAO study prepared for Senator Bentsen (then chair of the Joint Economic Committee).<sup>1</sup> Senator Bentsen had been calling for an import surcharge levied against all imports from Japan, but dropped this idea by the time the report was issued.

Second, while capital inflow has filled the gap between domestic savings and investment, permitting a level of investment higher than would have been the case otherwise, this strategy came with real costs. Payment of interest or repatriation of profits on the stock of foreign investment represents a real transfer of future resources abroad (unlike the domestic redistributive effect of domestic debt). The fundamental question is whether the investment/growth impact of the net inflow of foreign capital outweighs the net loss from the repatriation of earnings. Since the Japanese may actually be losing money on their investments, perhaps the bargain was a worthwhile one for Americans. More seriously, the major outcome was not so much a rise in domestic investment as simply a widening of the federal budget deficit, driven by the combination of tax cuts and increased defense spending. It is far from clear that this was the best possible outcome for the nation over the course of the decade. A pattern of smaller government deficits, permitting the financing of domestic investment without a net inflow of foreign capital might well have been a preferable pattern.

Japan, too, may have reasons to be dissatisfied with its large current-account surpluses. Management of foreign assets--portfolio, real estate, and overseas subsidiaries--all posed at least a transitional problem for Japan given the acute shortage of employees endowed with the necessary international skills to manage these assets. Despite allegations in the late 1980s

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<sup>1</sup>General Accounting Office, United States-Japan Trade: Issues and Problems (GAO, ID-79-53, September 21, 1979). See especially pp. 151-171.

that the Japanese were acquiring great power over the world because of their creditor position,<sup>2</sup> the reality seems to be more one of a reluctant, inept, and naive investor. Major losses in property markets, international financial markets, and even the operation of some manufacturing subsidiaries attest to these problems. Nevertheless, given the unusual degree of Japanese isolation from the outside world in the earlier postwar period, these transitional problems are largely a welcome development.<sup>3</sup>

Second, the Japanese face an important cyclical problem at the present time. The expectation of the Ministry of Finance appears to have been that export expansion in 1993 would carry the economy out of recession, repeating the traditional business recovery process of the 1950s and 1960s. To pursue economic recovery through exports at a time when other major nations were experiencing low or negative growth amounts to an export of unemployment to other G-7 countries. Global economic conditions in 1993 are considerably different from the early 1980s, when Japan last exported its way out of a domestic slowdown. Whatever the narrow economic merits of an export-led recovery, this has serious political risks for Japan. These risks are exacerbated by the large size of Japan; when it pursued export-led recovery from economic slowdowns in the 1950s and 1960s, Japan was a small nation with a minor impact on the rest of the world.

Economists should also keep in mind that our sterile models of surpluses/deficits, capital inflows/outflows all have important social and political implications. Even if a net

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<sup>2</sup>See for example, Daniel Burstein, Yen! Japan's New Financial Empire and Its Threat to America (Fawcett, 1990).

<sup>3</sup>Edward J. Lincoln, Japan's New Global Role (Brookings, 1993) details the earlier isolation or insularity, and the major transformation that took place in the 1980s.

inflow of capital represented an economically rational American response to its economic situation in the 1980s, the result was severe competition for many American manufacturing industries or firms--including some that were efficient and well managed--as well as a rapid rise in the proportion of domestic assets that were foreign owned (after three-quarters of a century of low foreign ownership).<sup>4</sup> These are major structural changes, with implications for job losses/gains in different industries or geographical parts of the country, and for arousing nationalist reactions against the intrusion of foreign ownership. Such dislocations or restructuring carry real economic and human costs, and it seems only natural that they lead to nationalistic resentment if the agent of change is competition from foreign firms. This may be especially an American problem, given the geographical size of the nation and the distinct lack of policies to ameliorate the personal costs involved in structural change. In general, political systems in deficit nations allow such foreign inroads to take place only if they have reason to be satisfied with the behavior of the surplus nations providing the competition and the capital associated with the changes. Japan, because it had not been a major investor prior to 1980, probably faced more attention with its large surpluses and capital outflow; Japan gained a visible presence abroad that had simply not existed before.

But were the deficit countries, and particularly the United States, sufficiently comfortable with the behavior of Japan to gracefully accept the economic and social intrusion represented by the trade imbalance and the rapid inflow of capital? This is the crux of the macroeconomic problem. The answer is no. The fact that a nation believed to have

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<sup>4</sup>David Hale, "Will We Hate Japan as We Hated Britain?" The International Economy, January-February, 1988.

relatively closed markets for goods and capital itself was becoming a major investor in the United States was unpalatable for many. When Britain faced chronic current-account surpluses in the 19th century, it suddenly espoused free trade (and, just as importantly, maintained an empire to absorb most of those surpluses without being able to argue back). When the United States faced chronic current-account surpluses in the postwar period, it, too, espoused free trade and engaged in policies to ease the "dollar shortage." What has Japan done to ease the way for international political acceptance of its current-account surpluses? Nothing, except to tell the world that the surpluses are a good thing. This seems like an especially inept response, and the dogged refusal to acknowledge problems of market access exacerbates the situation.

Until Japan can demonstrate to the satisfaction of its trading partners that its markets are easily accessible, large current-account surpluses will continue to face strong resistance that is quite understandable. It is for this reason that the recent Advisory Committee on Trade Policy and Negotiations (ACTPN) report emphasizes that "while economists may argue that the trade deficit [with Japan] is not important, it has become a political lightning rod that is seriously undermining the relationship."<sup>5</sup>

In addition, from a global perspective, a Japanese current-account surplus that is, to a large extent, with the United States, may not represent an efficient flow of international capital. One would expect that the economically efficient international flow of capital should be from developed countries to developing countries, and now, to those former communist

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<sup>5</sup>Major Findings and Policy Recommendations on U.S.-Japan Trade Policy: Report of the Advisory Committee for Trade Policy and Negotiations, January 1993, p. 13.

countries undergoing systemic transformation. The rate of return in developing or transforming countries ought to be higher than in mature industrial countries, although this has often been negated in reality by the much higher risk factor caused by political instability in developing countries. Why, though, should a large net flow of capital from Japan to the United States be the most efficient or desirable choice for the global economy? Alteration of policies in both the United States and Japan to diminish the bilateral transfer, while maintaining the flow to developing countries ought to be desirable for long-term global economic welfare.

Finally, the argument that Japan and the United States should simply decide what is best for their own economies is flawed as well. The Japanese response to American complaints about the macroeconomic situation has been rather consistently to tell the Americans to get their own house in order if they are not satisfied. But both nations live in an interdependent world. I wonder how seriously Japanese government officials really wanted the United States to reduce the "twin deficits" in the 1980s, since the United States represented such a convenient outlet for Japanese overseas investment during the 1980s. Without the United States as such a large absorber of Japanese surpluses, it is quite likely that Japan would have faced a situation quite similar to the recession of 1992-1993 in the early 1980s instead.

Believing that Japan should be completely free to set its macroeconomic policies also ignores the recent history of international interaction. Notions of G-7 responsibility for global growth have been around since at least the days of the "locomotive theory" of 1976-1977, even if the mechanisms for obtaining coordination are poor. Japan is currently in the midst

of recession, but is in the best position of any G-7 member to stimulate its economy through fiscal policy at the present time. The rapid rise of the current-account surplus is a consequence of the recession and failure to stimulate demand. Even if the current-account surplus *per se* is not a problem, certainly recession and the resistance of the Ministry of Finance to fiscal stimulus are issues of legitimate international concern from this global perspective.

Assuming that both nations, or the broader G-7 desire to stimulate growth or reduce current-account imbalances, some degree of cooperation is necessary. But how is that cooperation to occur? The approach preferred by the signers of the Bhagwati letter to President Clinton and Prime Minister Hosokawa seems to be the traditional economics approach: if a set of economics experts explains carefully and rationally to the Prime Minister that fiscal stimulus is a desirable policy for Japan, then surely such policies will materialize.<sup>6</sup> But suppose this approach does not work? Academic persuasion seems rather naive in this case.

The letter decries the use of macroeconomic targets, but perhaps we should recognize that such suggestions have arisen precisely because academic explanation or friendly persuasion has not worked. We readily accept the notion of targets for domestic macroeconomic variables, such as the reduction of the federal budget deficit, as mechanisms to force the political and bureaucratic actors involved to come forth with policies that have a real impact even though the targeted variable may be subject to uncontrollable influences

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<sup>6</sup>"An Open Letter to: Prime Minister Hosokawa and President Clinton," September 25, 1993, signed by Jagdish Bhagwati, Paul Krugman, and others.

which make achievement of the target difficult (as is the case even with the federal budget deficit, since tax receipts vary with the pace of economic growth). Why, then, are we so reluctant to recognize the value of similar mechanisms in an international context?

Economic policy formation in the domestic American context has always been a passionate exercise with active disagreements, imposition of targets/promises/limits, severe criticism when targets are unmet, and conflicting interpretations of outcomes. Why should the international context be any different? Are the Japanese so delicate that they can not withstand a little criticism? I believe that the bilateral relationship is sufficiently robust that it can and should withstand a considerable amount of pressure. If Japan were to commit itself to some sort of target for its current-account surplus, and failed to meet the targets, it would be criticized. So what?

The answer to this question is fear that beyond criticism, the United States would resort to some form of retaliation in the even of Japanese failure to achieve macroeconomic targets. I doubt that reaction to failure would go beyond congressional resolutions or press conferences by cabinet secretaries, unless the failure were due to (unlikely) wilful rejection of the requested macroeconomic policies by the Japanese government. In such a case, retaliation, or at least the threat of retaliation is a possibility. This would be a dangerous precedent, and perhaps represents a serious enough possibility to avoid targets. Nevertheless, I certainly wish that the reverse had taken place in the 1980s, when Japanese retaliation against American macroeconomic failures (the inability to deal with the budget deficit) in the form of controls on capital flow from Japan to the United States (as difficult as such a policy would have been to enforce) might have had a favorable impact on the U.S. policy discussion.

If targets are repugnant in a bilateral context, an alternative approach for them might be for the G-7, OECD, or IMF to act as the body which announces non-binding macroeconomic goals, with nations failing to meet their goals to explain their failures at meetings of these bodies.

In reality, the issue of macroeconomic targets appears to be moot. The framework agreement of July 1993 did not include any specific targets on current-account surpluses because of Japanese government resistance. To me, that resistance represents a lack of fundamental Japanese government (and primarily Ministry of Finance) commitment at that time to any real fiscal expansion policies to stimulate domestic demand and reduce the current-account surplus. Instead, we have had to rely on having senior U.S. government officials criticizing the fiscal policy stance of the Japanese government, and calling for expansion through a tax cut. Some see even this as unfair or unjustified interference by Americans in the internal affairs of Japan. But if we are in a situation where the United States is actually making some progress on correcting its own macroeconomic imbalances, needs Japan to cooperate in the process because of the mutuality of these relationships, but faces severe resistance from the Ministry of Finance, should U.S. government officials really refrain from criticizing Japanese policy? I think not.

The only legitimate argument that could be made in the fall of 1993 was that Prime Minister Hosokawa was personally in favor of real fiscal stimulus, supported by most elements of the business community, and some government ministries. He was, therefore, likely to win the battle with the Ministry of Finance without American assistance. This contrasts with the more uniform front in opposition to fiscal stimulus presented by the LDP

governments from the early 1980s until the fall of Miyazawa in 1993. By September of 1993, it seemed pretty clear that real fiscal stimulus in the form of an income tax cut would be approved by the end of the year because of the seriousness of the continuing recession. Nevertheless, one could argue that properly timed American statements may well result in a final decision for a degree of fiscal stimulus that will exceed what would otherwise materialize. What has been, and what should be, involved in this process are not threats of retaliation, sanctions, or other drastic measures, but simply the inclusion of comments by high U.S. officials about the importance of macroeconomic stimulus in Japan when such comments are deemed appropriate. As long as such statements are planned in a manner to accomplish goals, rather than simply representing angry backlash against perceived intransigence, they are an appropriate part of bilateral relations.

In the longer run, the Japan's current-account surpluses should decline and disappear, driven largely by the rapid demographic changes taking place. This shift may take place by early in the next decade, but it is extremely difficult to predict. Meanwhile, the surplus could be quite high for the next several years, raising all the political concerns discussed earlier. Furthermore, complacency over the long-term change does not offset the problem of cyclical timing in 1993.

In summary, Japan's present large and rising current surplus is a matter for legitimate international concern for both economic and political reasons. Continued policies to reduce the U.S. fiscal and current-account surplus are necessary, and require reciprocal Japanese adjustment. Substantial pressure--through targets or public criticism of Japanese macroeconomic policy--is a legitimate and necessary part of the process when carefully timed

and calibrated to positively affect the policy process in Japan.

### Microeconomic Problems

Mutual economic gains from trade is one of the few bits of economic theory on which virtually all economists agree. Terms such as comparative advantage and free trade have passed from being theoretical economic constructs to tenets of ideology imbedded deeply in American politics. However, the comparative static models by which these concepts are explained to students have many shortcomings for policy makers trying to make progress toward the ideal.

The essential problem comes from the process of removing or lowering barriers. Some purists seem to believe that free trade is such a clearly beneficial concept that a nation should simply adopt free trade unilaterally. Or conversely, there is the oft-heard argument that if the Japanese wish to follow protectionist policies, we should not care because they only hurt themselves.

Economically this argument may be flawed. If a firm can protect a portion of its market, and thereby raise prices in that market segment, it can then cross-subsidize to meet or undercut competition in other markets (a pattern that has concerned economists since at least the short-haul/long-haul railroad rate problems of the late nineteenth century). If, in addition, technical change depends critically on generating profits, a firm with a segmented market and excess profits in the protected portions of its market may gain additional long-run advantages

over its competitors.<sup>7</sup> A world in which one nation unilaterally adopts free trade while others do not could easily result in a one-shot static efficiency gain but a long-run deterioration in economic performance due to the inability to continue moving resources into higher value-added industries because of advantages obtained by foreign firms working from protected bases.

Because of such dangers inherent in unilateral trade liberalization, the world operates under a much more pragmatic institutional framework. Under the GATT, the only real principle is that of most-favored nation; nations may or may not choose to lower their trade barriers, but if they do, the deal cannot be restricted to one nation. In essence, the resulting process under the GATT has been a recursive game. Players choose to strike bargains, partially opening their own markets in exchange for concessions by trading partners believed to be roughly reciprocal. Continuation of the game depends on perception of the outcomes of previous rounds; if players are convinced that they received benefits equalling or exceeding the costs, they will play another round.

This game was complicated by the existence of the cold war, in which the United States had non-economic motives for playing regardless of the behavior of its trading partners in order to solidify alliance relationships. From the time of the switch in occupation policy in 1947, the emphasis was on promoting economic recovery in Japan. As C.G. Allen put it, this was motivated by the fact that "the widespread economic distress provided an uncongenial

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<sup>7</sup>This is essentially the sort of model underlying Laura D-andrea Tyson, who's Bashing Whom? Trade Conflict in High-technology Industries (Institute for International Economics, 1993), with the extension that in Japan and Europe governments systematically create both protected markets and subsidies to alter the terms of competition to their advantage.

environment for the growth of new democratic institutions."<sup>8</sup> Edwin O. Reischauer echoed these attitudes, writing that "in the divided world that resulted from Communist intransigence, an economically unhealthy Japan was a serious liability to us rather than an asset."<sup>9</sup> In the minds of U.S. government officials, an economically healthy Japan included permitting heavy protectionism on both merchandise and capital imports, out of an infant industry rationale. Japan was clearly viewed in this manner in the 1950s, when the U.S. government deliberately refused to further the interests of leading American businesses in Japan.<sup>10</sup>

Because of the cold war, therefore, the recursive game of market opening was skewed, with Japan permitted to maintain strong barriers into the 1960s. Belatedly, these barriers began to come down, in a process that continues today. But the critical element here is that in the 1980s--and today--a growing number of American firms, unions, and government officials perceived that the process had not been reciprocal. The necessary underpinning for continuation of the process, therefore, was weakening, evidenced by the increased incidence of American protectionist actions in the first half of the 1980s directed at Japan. Especially during the 1980s, when relatively open markets for goods and capital in the United States, combined with a prolonged period of dollar strength, contributed to extensive economic restructuring (attended by geographical relocation of industry and the unemployment and

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<sup>8</sup>C. G. Allen, Japan's Economic Expansion (New York: Oxford University Press, 1965), p. 17.

<sup>9</sup>Reischauer, The United States and Japan, p. 293.

<sup>10</sup>Mark Mason, American Multinationals and Japan: The Political Economy of Japanese Capital Controls, 1899-1980 (Harvard University Press, 1992) pp. 101-198, describes a number of specific episodes in which the U.S. specifically declined to assist American businessmen in their efforts to overcome barriers to entry in Japan in the 1950s.

other labor costs associated with those changes), dissatisfaction mounted concerning the status of access to Japanese markets. Despite some episodes of protectionist actions at home, however, the strength of American commitment to open markets meant that the main thrust of policy was to pressure Japan to lower its barriers.

The nature of the continuing access problems to the Japanese market are now fairly well studied. Marcus Noland's recent paper provides an excellent summary of the arguments and problems.<sup>11</sup> Exceptionally low levels of manufactured imports relative to GDP (or to GDP in manufacturing), low levels of intra-industry trade, low levels of inward direct investment, all cause Japan to stand out in comparison with other industrial countries. While some of the difference can be explained by standard economic variables, I am simply not convinced that these provide the entire explanation. Furthermore, the argument that all the differences are due to standard economic factors is totally at odds with the plethora of anecdotes about the extraordinary informal problems in doing business in Japan for foreign firms in many industries. While anecdotes may be an unreliable basis for analysis, any econometric analysis which completely negates or contradicts the evidence of actual business experience is suspect.

Some firms operating in open markets will have competitive problems; this is simply the normal outcome of competitive processes. If the set of firms bringing complaints to Washington consists solely of the failures, while the successful firms remain largely silent, then the anecdotal evidence could provide a very skewed picture of the situation. However,

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<sup>11</sup>Marc Noland, "United States-Japan Trade Friction and Its Dilemmas for U.S. Policy", based principally on the new book by C. Fred Bergsten and Marcus Noland, Reconcilable Differences? (Institute for International Economics, 1993).

one of the remarkable characteristics of the U.S.-Japan relationship is that some of the most successful firms are among the vocal critics. Companies that actually do substantial business in Japan, have a major commitment to understanding and adjusting to local customs, language, and rules, often express deep dissatisfaction with the nature and impact of the barriers thrown in their path relative to what they experience in other foreign markets. Among these firms are Motorola, Texas Instruments, Cray Computer, AT&T, and even Boeing Aircraft (with this latter firm generally positive in public, but quite candid in private about explicit pressure from MITI to increase the amount of value-added performed by Japanese subcontractors). These are firms that ought to be among the staunchest defenders of the bilateral relationship; often they are not. More broadly, the ACCJ, an organization often assumed to consist of the successful, satisfied, quiet American firms, recently behaved uncharacteristically by issuing a report quite critical of market access conditions.<sup>12</sup> The fact that firms that ought to provide the constituency for harmony are part of the chorus of complainants suggests the depth of the problems.

Many of the indicators of foreign penetration of Japan increased over the period from 1985 to 1990, and the result was optimism concerning the direction of change. Japanese government officials pointed to the rise in the ratio of manufactured imports to GDP, or the rise in intra-industry trade and declared the problems to be gone.<sup>13</sup> The ACCJ at that time

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<sup>12</sup>American Chamber of Commerce in Japan, 1993 United States-Japan Trade White Paper.

<sup>13</sup>Among these efforts to refute the conclusion of Japan as an outlier on trade and investment are Mitsuo Hosen, "Heisasei Hihan e no Hanron" [a Response to Criticism of Closedness], Keizai Senta Kaihō, No. 619 (November 1990), Ryutaro Komiya and Kazutomi Irie, "The U.S.-Japan Trade Problem: An Economic Analysis from a Japanese Viewpoint," Discussion Paper Series, No. 90 (Tokyo: Research Institute of International Trade and Industry, May 1990); and Satoshi

commissioned a study by A.T. Kearney which interviewed American firms operating in Japan, and found most firms agreeing that the trade and investment environment had improved in the previous five years (without putting any quantitative dimensions on how sizable the improvement had been).<sup>14</sup>

In retrospect, some of the change from 1985 to 1990 was inspired by an unsustainably high level of economic growth. The combination of five percent economic growth for several years, as well as asset inflation, induced an unusually rapid increase in imports, as one would expect. Imports of motor vehicles, for example, rose from \$571 million in 1985, to \$6.4 billion in 1990, but then dropped substantially to \$5.2 billion in 1992.<sup>15</sup> Overall, the ratio of manufactured imports to GDP rose from 2.6 percent in 1985 to 3.8 percent in 1990, but then subsided to approximately 3.0 percent by 1992.<sup>16</sup>

If the improvement in foreign market access in Japan was due to a set of extraordinary economic circumstances in the late 1980s, then substantial cause for concern remains. Recent upward movement of the yen provides a increased price advantages for foreign products in theory, but the recession may make penetration more difficult, at least for industrial products

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Kuwahara, "The Fallacy of Trade Ratios," Journal of Japanese Trade and Industry (January-February 1992).

<sup>14</sup>American Chamber of Commerce in Japan, Trade and Investment in Japan: the Current Environment, A Study for the American Chamber of Commerce in Japan Prepared by A.T. Kearney (Tokyo: ACCJ, 1991).

<sup>15</sup>Bank of Japan, Balance of Payments Monthly, May 1993, p. 18.

<sup>16</sup>Edward J. Lincoln, Japan's New Global Role (Brookings, 1993), p. 86, and Isaiah Frank, "The U.S.-Japan Economic Relationship," paper prepared for the Committee for Economic Development, July 1993, p. 47. The ratio in for the United States, meanwhile, is close to 8 percent, and for European countries 10 percent and above.

purchased by corporations which may be more reluctant to switch to a foreign product at the expense of a domestic supplier in a time of economic difficulty.

In the long run, stagnation and decline in the size of the labor force implies higher labor costs, leading to a further shift toward imports, at least for labor-intensive products. If this process, though, relies heavily on Japanese firms importing from their own subsidiaries abroad, then the concerns of non-Japanese-affiliated firms will remain. Somewhere in the process of structural change, non-affiliated foreign firms must see greater advantages and opportunities within Japan for themselves if they are to continue their support for a liberal trade regime.

How do we achieve progress on these problems? The problems raised above have led some to advocate managed trade, or voluntary import expansions (VIEs) as a solution, following along the route taken in semiconductors in 1986 and automobile parts in 1992. I find myself largely, but not entirely, opposed to such solutions.

Managed trade is bad economics, negates our decades-long advocacy of less Japanese government intervention in the market, and undermines the global liberal trade framework. Why then, could anyone advocate it as an acceptable solution? There are two reasons why it is not a total loss:

First, managed trade, and particularly the semiconductor agreement, became a powerful threat to the Japanese government and private sector. MITI played an important role in making the semiconductor agreement work, but it probably paid a major political cost in its relationship with Japanese industry in so doing. Industry resented the intrusion of MITI, and expressed its dissatisfaction. The lesson for the Japanese government is that, if

this painful process is to be avoided, then rules-based settlements had better be fully implemented and the anticipated impact of the change in the rules on trade flows had better occur.

Second, think of managed trade as a form of affirmative action. One could argue that labor markets worked efficiently in the United States in the 1950s; firms hired those people who they believed to be the best qualified for managerial positions, and who would fit best into their corporate cultures. Those people just happened to be almost entirely white males. As a nation, we then chose to introduce inefficiency into the market, forcing firms to hire women, blacks, and other ethnic minorities as a matter of social policy. While this may have caused economic inefficiency in the short run, the long-run impact was to alter social attitudes and behavior, with firms learning the economic value of women and minorities. Discrimination in American labor markets may not be gone, but the situation is far different from what it was 30 years ago, and Americans generally believe that their society and economy is better off because of the change.

Managed trade is the international equivalent of this social policy. As part of the general insularity and nationalism of Japan's development in the postwar period, Japanese firms have often preferred limiting their business associations to other Japanese firms whenever possible. The problem with semiconductors, for example, was primarily that Japanese firms would not even talk with foreign manufacturers. Without dialogue, sales and business relationships cannot even begin. The semiconductor agreement forced reluctant Japanese firms together with American and other foreign suppliers. The outcomes may not always be happy ones (just as they were not in American affirmative action policy on

employment), but the desired outcome is that fruitful and economically efficient business relationships will evolve as the result of this pressure. The stories one hears of reluctant (and angry) Japanese firms buying inferior, low quality U.S. semiconductors because of MITI pressure and simply dumping them in the harbor may not be entirely apocryphal, but surely foreign market penetration did not rise from less than 10 percent to 20 percent on this basis.

Unlike affirmative action, however, widespread use of managed trade could have a very detrimental impact on the principle of liberal trade. Hopefully, limited (in number and duration) episodes provide an example to the rest of Japanese industry concerning the desirability and profitability of increased dealings with foreign firms.

The argument concerning managed trade pushing Japan in the wrong direction should not be ignored either. A VIE results from bilateral agreement, with the importing government implementing policies to yield the agreed-upon result. In 1986 and 1992, the Japanese government was willing to enter into such agreements (although it denies that the agreements actually represented VIEs), and many Americans see this willingness as logical or natural given the context of extensive government involvement with the private sector. However, this willingness may be changing. Some in Japanese society have disliked this pattern of government involvement and guidance, and now their voice is louder. In particular, Prime Minister Hosokawa and his coalition government appear to be genuinely interested in economic deregulation, and the domestic business community appears to support his initiatives. Earlier efforts at change, such as the Maekawa report of 1986, generally called for change for the sake of "international harmony." No nation undertakes major domestic reform in order to please other countries (except, perhaps, small developing countries with large debt

loads under pressure from the IMF). This time the pressures seems to be largely domestic; deregulation is desired in order to improve the efficiency and growth of the economy, a far more powerful rationale for generating policy change.

Domestically motivated deregulation is an important development, and one which the U.S. government should encourage. However, I am not convinced that the mood for deregulation by itself will necessarily create a better reception for foreign firms and their products. The discussion in Japan is almost solely on economic deregulation, but often the regulatory obstacles for foreign firms have been excessive health or safety regulations being put to use as trade barriers. If these issues are not addressed, many problems will remain. Furthermore, much of the economic deregulation of interest to domestic industry may have little benefit for foreign firms. This suggests that an American government voice will be necessary in this process, ensuring that deregulation does not ignore the needs of foreign firms.

Deregulation might also leave some problem areas because industrial policy will not disappear, and as long as the government has some favorite industries which it wishes to promote (such as super computers, medical equipment, telecommunications equipment, and other high technology industries), market access is likely to be a problem in those areas. Political deadlock between a resistant Japanese government and an insistent U.S. government may still lead to further episodes of managed trade as the only viable (but reluctant) solution to such problems even in the midst of an overall movement toward less regulation. One hopes, though, that the negative imagery acquired by VIEs in Japan due to the semiconductor and automobile parts episodes will lead the Japanese government to carry out traditional

rules-based changes which have a real impact on market penetration.

On the other hand, the changed mood in Japan may actually help bring genuine openness in some problem areas where little progress has occurred in the past. In the construction sector, where a decade of pressure had achieved little, the Japanese government recently agreed to competitive bidding. In this case, the threat of retaliation under section 301 of the U.S. Trade Law (plus the embarrassment of construction-related political scandals) led to a potentially important change without very much public squabbling.<sup>17</sup> This is somewhat surprising given the past record of negotiations in this area, and the relatively radical approach pushed by the U.S. government. Whether this important change actually leads to real changes in behavior by those officials administering the contract system, and in increased penetration by foreign construction, engineering, and architectural firms remains to be seen.

Focusing on VIEs may obscure what I feel has been a useful innovation in American policy. While some in the administration have certainly advocated extensive use of managed trade, the real shift has been the creation of a monitoring or follow up function in bilateral relations. Part of the problem and frustration on the part of American negotiators in the past has come from a failure to follow through on trade agreements. The use of "objective criteria" in the framework agreement is not managed trade; it is simply a sensible decision to monitor outcomes. Failure of statistics to show increased market penetration does not necessarily imply retaliation (although this can be a useful negotiating tool), but may imply the need for further negotiations to solve remaining problems. The system may also lead to

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<sup>17</sup>Paul Blustein, "Japan's Move Eases Threat of Sanctions," Washington Post, October 27, 1993.

greater compliance with the newly negotiated rules, so that the Japanese side can attend these monitoring sessions and argue that whatever happened to the statistics, it could not be from failure to carry through the agreement. One wonders why such an approach was not put in place many years ago.

The critics see monitoring as only a thinly disguised VIE policy. The implicit message in "objective criteria" is that market penetration statistics had better reach higher levels or else some form of retaliation may well materialize. That may be the case in some negotiations. But I believe that the larger impact will be to focus attention on the real implementation of rules-oriented agreements; real implementation should lead to real increases in market penetration by foreign firms in many of these cases.

### Conclusion

The views expressed above add up to a rationale for continued American pressure on Japan on both the macroeconomic and microeconomic front. Important changes have taken place concerning market access in Japan over the past decade; doing business in Japan is easier today for many firms than a decade ago. Nevertheless, important asymmetries remain. As long as this is the case, Japan will find that international acceptance of its large current-account surpluses will be weak, putting it under pressure to reduce those surpluses or undertake more thorough market opening measures. Support for liberal trade will erode if American firms continue to believe that they are unduly disadvantaged in the Japanese market. Solution to some of the more difficult problems may require radical departures from the principle of rules-based negotiations to include episodes of VIEs, although fear that the

Clinton administration will move heavily in this direction is unfounded.

Despite the focus on problems in this paper, I remain fundamentally optimistic. Japan is changing; stagnation in the labor force, lower prospects for average economic growth, and the strengthened yen all point in the direction of higher import levels. Rising levels of travel, education, and work abroad create a more sophisticated citizenry less willing to tolerate high prices at home. Even with imbalances or asymmetries, the existing extensive nature of bilateral economic ties implies an underpinning of willingness to work out problems so that the relationship can expand.

Noise, and considerable amounts of it, may simply be inevitable in this relationship. Just as every foolish violation of first amendment rights in the United States does not really have the dangerous "chilling effect" on the first amendment usually claimed by the ACLU, neither do the trade disputes or occasional managed trade solutions necessarily have a chilling effect on liberal trade. We will muddle through, and the long-run direction of change will continue to be in the direction of moderate increases in access to the Japanese market.