Cornell International Law Journal

Volume 22
Issue 3 *Symposium 1989*

Article 7

The Trade Imbalance Isn't the Problem

T. J. Pempel

*T.J. Pempel**

The Trade Imbalance Isn't the Problem

Once each month the United States Department of Commerce announces the nation's trade balance for the previous month. Invariably of major attention is the specific figure for bilateral trade between the United States and Japan. In recent years this has constituted about one-third of total U.S. Trade. For a week to ten days prior to the announcement, stock market traders, Federal Reserve officials, interested politicians and economic pundits of diverse ideological stripes offer predictions on what the number is likely to be, the meaning of specific ranges of numbers, the presumed policy implications should the number be up or down over the prior month and so forth. Inevitably, the actual announcement is then followed by a similar flurry of instant analysis, while behavior on the U.S. stock and bond markets for the next several days is widely alleged to have been heavily determined by the announced numbers.[1]

Bilateral merchandise trade between the United States and Japan has become one of the most widely cited indicators in the general and financial press within the United States. It has become one of the most frequently employed weapons in the arsenal of daily political debate concerning the nature of the United States-Japan relationship, as well as America's economic and strategic position in the world. Partisans to the debate typically congregate around one of two rather bifurcated positions. On one side are those who argue that Japanese products sell well primarily because of quality and cost, that the Japanese market is largely open, that formal tariff levels and other trade barriers in Japan have been reduced to levels at or below those of any other industrialized country, that the Japanese government and private industry have made great efforts to attract foreign imports to Japan, and that the failure of

* Professor of Government, Cornell University.

1. Occasionally, the numbers are "worse" than predicted, and the markets do well, such as happened in mid-January when November's "terrible" figure of a jump of 22% in the trade deficit was announced and the Dow Jones Industrials rose 24 points. Then my local headline read "Market Shrugs Off Trade Deficit, Soars 24 Points." Honolulu Advertiser, Jan. 19, 1989, at C-9. The point here is that regardless of any actual link, people in various walks are acting as though there is a link.

the United States to export more to Japan lies largely with the U.S. government's failure to rectify its massive national budget deficits, and with private industry's failure to "try harder" within the Japanese marketplace.[2]

Juxtaposed against such positions are those holding that Japan's overseas successes are aided by a welter of government programs and oligopolistic practices; that although formal tariff levels may indeed be low, beneath them lies a subterranean maze of non-tariff barriers designed to keep out or constrain a vast array of American products. The evidence adduced is the bilateral trade figure, which was roughly even in 1973, and then jumped to $10 billion in favor of Japan in 1980, $15 billion in 1981, $33 billion in 1984 and to around $60 billion annually since 1986. If the Japanese aren't doing something funny, the argument goes, such a shift would have been impossible.[3]

To this abstract macro-level criticism is added an amusing arsenal of anecdotes, from former Secretary of State George Shultz's complaint that his morning glass of orange juice at Tokyo's Imperial Hotel cost over $10; to the many journalistic reports concerning honeydew melons costing $2 in California but selling for $30 in Tokyo; to the hoards of Japanese tourists who allegedly find it cheaper to buy Japanese cameras at New York's 47th Street Photo than in comparable shops in Shinjuku. The result for many American policymakers has been an undeniable portrait of an open America and a closed Japan.

Certainly the latter position is one with which most Americans, particularly business leaders, politicians, and journalists, are familiar. Most are usually quick to cite concrete examples to demonstrate alleged dumping of Japanese televisions or semiconductors, while being equally quick with examples designed to show just how closed to American manufactured goods the Japanese market really is. Thus, when American exporters of aluminum baseball bats began to gobble up large shares of the market in Japan, suddenly the size, shape and, by at least one account, the sound, of the American imports were declared inappropriate for Japanese batters, and the American product was shut out in favor of presumably lower quality, but more culturally acceptable Japanese equivalents. Even though Japanese manufacturers produced nothing comparable, paddle ball rackets for the American Club in Tokyo were

2. This brief paragraph obviously summarizes a wide array of positions, but it is close to the official position of the Japanese Ministry of International Trade and Industry. *See also* T. SATO, THE U.S.-JAPAN TRADE IMBALANCE FROM THE JAPANESE PERSPECTIVE (National Bureau of Economic Research Working Paper No. 2497, Jan., 1988).

3. This position can be found most strongly among U.S. congressmen such as Senator John Danforth and Representative Richard Gephart. In 1987 Representative Gephart offered an amendment to a trade bill that called for investigation of trade barriers in any nations having large bilateral surpluses with the United States. His views were also made clear during the 1988 Democratic primary elections. A more nuanced, but still highly critical piece can be found in C. PRESTOWITZ, TRADING PLACES: HOW WE ALLOWED JAPAN TO TAKE THE LEAD (1988) (chapter 3 summarizes many of the competing viewpoints on the bilateral trade issue).

held up at customs for several weeks as officials queried the purchasers as to their need for such foreign merchandise. The story of European skis has been well reported. Allegedly Japanese government officials declared that European skis which had come to achieve a high level of customer appreciation in Japan could no longer be considered safe for Japanese slopes and customers since they had been tested on the allegedly quite different "European snow," not the most assuredly uniquely different "Japanese snow."[4] Finally, Japanese officials anxious to keep out imports of vastly cheaper, and allegedly quite as good, American rice declared foreign rice to be a health hazard for Japanese consumers since (as is apparently well known) Japanese intestines are significantly longer than Western intestines.

As a consequence of such ridiculously close-minded opposition to specific products, it is hard for many Americans to take seriously official Japanese claims that their markets are formally open and foreign competition is welcomed. For many Americans, the causes of the current trade imbalance unmistakably lie with a deceitful and manipulative Japan, getting a "free ride on defense" while achieving through economic means what it failed to achieve militarily during World War II. If the trends continue, they argue, the United States will become "the New Manchuria," supplying inexpensive agricultural and other primary products for processing in Japan, while serving as the principal market for Japanese manufactured goods. Or as it has been alternatively formulated: if current trends continue, the United States will be the world's largest manufacturer of ICBMs and hamburgers and the Japanese will make everything in between.[5]

It is not surprising that over the past several years the official U.S. response to its trade deficit with Japan has moved from multilateral and macro-economic approaches to an insistence on so-called MOSS (market oriented, sector selective) negotiations designed to examine ways to overcome obstacles to U.S. marketing success in specific sectors of the Japanese market, such as timber, wine, electronics, tobacco and the like.[6] As these have proven incapable of rapid rectification of the trade deficit, some post-MOSS thinking now focuses on even more explicit guarantees of specific market shares or total sales for U.S. companies on a sector-by-sector or product-by-product basis. In short, some in the

4. With suitable apologies to the various native inhabitants of the Alaskan and Canadian tundras, who according to widely cited linguistic examples have languages which recognize dozens of types of snow, it is hard to believe that there was any factual basis to the Japanese claims.

5. I first heard this phrase from Professor Chalmers Johnson, University of California, San Diego, at a forum in 1983. It has been widely repeated since.

6. The MOSS talks were begun as a result of a request from President Reagan to Prime Minister Nakasone in late 1984, and the talks began in Tokyo in January, 1985 with the first items targeted being telecommunications, pharmaceuticals and medical equipment, electronics and forest products.

United States now demand managed trade.[7] Anything less, it is alleged, will be proof that Japan is not truly open to American competition. If such actions do not "force" open the Japanese market to America's presumably superior products, the U.S. government would be urged to engage in *quid pro quo* restrictions of its markets.[8]

Others take a different political tack, contending that the U.S. must refocus its efforts at becoming more competitive in the export of manufactured goods. This means in many ways "out-Japanizing", the Japanese: a focused industrial policy, reduction in anti-monopoly regulations that prevent information sharing, more engineers, more collaborative research and development, longer time perspectives for U.S. corporations, and the like. All of these would be designed to strengthen the U.S. industrial and manufacturing base.[9]

These latter arguments partly parallel official Japanese reactions to the bilateral trade deficits. Japanese views seem roughly to be that for every example of baseball bats, skis or paddle balls, they can cite an American company which sought instant success in Tokyo or Osaka by sending its former Brazilian or Italian market manager to Japan with no long term strategy, no Japanese language executives, and expectations of success in weeks, not years, only to leave in frustration when orders did not pour in, complaining about the "closed Japanese market." Many Japanese would argue that Americans are failing to get their own house in order, while the U.S. government remains excessively supine before various specialized interests unable to compete effectively in the world markets. Besides, they ask, just how important are baseball bats, skis, tobacco, and orange juice within the broader framework of a liberal trade regime, Japan's recent market opening measures, and the actual successes of many Western firms doing business in Japan.[10] They happily side with those in America urging more focus on industrial competitiveness and macro-economic policy adjustments within the United States, though they part company when suggestions arise for retaliation if the trade balance does not show rapid reorientation.

The battle thus rages. As Stephen Krasner succinctly phrased it: "On the U.S. side, there are persistent accusations that the Japanese are not playing by the same rules. On the Japanese side, there is the perception that Americans are tailoring their interpretation of the rules, if not

7. *See, e.g.*, Baucus, *A New Trade Strategy: The Case For Bilateral Agreements*, 22 CORNELL INT'L L.J. 1, 8, 12-14 (1989).

8. The Omnibus Trade and Competitiveness Act of 1988, § 301, 19 U.S.C.A. §§ 2901, 2411, with the so-called "super 301," is a recent indication of the actual political trend in this direction.

9. One of the best formulations of this argument is Zysman & Cohen, *Double or Nothing: Open Trade and Competitive Industry*, 61 FOR. AFFAIRS 113 (Summer 1983). *See also* S. COHEN & J. ZYSMAN, MANUFACTURING MATTERS (1987).

10. In addition to the Japanese complaints, there is more academic evidence supporting the claims of United States particularism in its protectionist efforts. *See* Goldstein, *The Political Economy of Trade: Institutions of Protection*, 1986 AM. POL. SCI. REV. 161.

the rules themselves, to suit specific circumstances."[11]

The entire debate, I wish to argue, while it has many valid components, is basically misguided. It is about the wrong data at the wrong time. In many ways, the debate is little more than a political manifestation of the old saw about the drunk groping around under a lamp post late at night in search of his car keys. Though joined in his search by a sympathetic policeman, after fifteen minutes of unsuccessful searching, no keys were to be found. Finally the policeman asked, "Are you sure you dropped them here?"

"No," replied the drunk, "I dropped them a block away."

"Then why are you looking here?" inquired the policeman.

"Because the light here is so much better," came the reply. Although the light may be better surrounding the bilateral trade balance figures, that is not the locus of the "real" problems.

I. What is Wrong with the Focus on the Trade Balance?

At one level the answer to the above question is, quite obviously, "nothing." Bilateral trade figures, like many other economic indicators, have a certain exactitude that conveys accurate and useful information. But it is a serious mistake to allow a single indicator to become a surrogate that masks a host of much broader and more complex problems. Implied in the trade numbers is some sense that they reflect to the second or third decimal point an undeniable snapshot of who is benefitting and who is losing in the economic relationship between the U.S. and Japan. Too often the focus on the bilateral trade relationship conveys the impression that the relative costs of a negative balance are disproportionately borne by the United States, its citizens, its workers and its businesses, while the corresponding benefits accrue principally to their Japanese counterparts. But to deal with such questions, the bilateral trade figure is totally inadequate.

The most obviously mistaken element in the bilateral trade discussion is that the bilateral economic relationship between Japan and the United States, important as it most assuredly is, remains only a small part of a much more complex set of links between the two countries that includes security, overseas aid, cultural and intellectual exchanges, and so forth. These bilateral ties, meanwhile, are embedded in, and constantly intertwine with, an even broader set of multilateral and regional relationships that are far more than bilateral in nature. While many who take specific positions on the economic and trade issues are occasionally sensitive to the interplay between bilateral trade and these other dimensions, all too often they are not. But obviously, the complex cultural, security, and political relationship between Japan and the United States and their links to broader regional and international currents transcend the simple numbers shown on the balance sheet for bilateral trade.

11. *Japan and the United States: Prospects for Stability*, in 2 THE POLITICAL ECONOMY OF JAPAN 403 (T. Inoguchi & D. Okimoto eds. 1988).

This is not the place for a detailed discussion of this issue, but U.S. bases in Japan; free exchange of books, magazines, orchestras, fellowships and students; joint economic aid to countries like the Philippines, Egypt, and South Korea; regional relationships among the United States, Japan and various Asian countries—are all items that have benefits completely ignored in the debates over Japanese automobile or video cassette recorder sales in the United States; or American citrus, meat, and tobacco sales in Japan. So too are the even broader security and defense alliances of both countries, the maintenance of a liberal trade and monetary regime, the freedom of cultural exchange, and so forth.

This is not to deny the importance of bilateral economic relations. They are indeed critical to both countries, and they must be analyzed as such. But even in this narrower context, the bilateral trade figures are hopelessly misleading. Probably the most important *economic* point to make about the bilateral trade balance is the obvious one that "nothing in economic theory implies that bilateral trade or current-account balances between any two countries must be zero. A country could have a zero balance on its global current account while having very large surpluses and deficits with all of its individual trading partners."[12]

Even accepting this broad caveat, there are a host of additional *economic* problems surrounding the wide use of the bilateral trade figures so widely cited in the United States. Several need to be highlighted. First, the bilateral trade figures are typically discussed in dollars, not in yen. Were they differently denominated, the recent picture on bilateral trade would appear very different. In 1986, for example, the Japanese trade surplus was up by 30.1% in dollars, but it fell by 7.6% in yen.

Second, the trade figures typically include only merchandise trade and do not include trade in services. For American companies, a good deal of profit comes from investments abroad, travel and transportation receipts, and other services such as finance, shipping, and the like. In these areas the United States does very well, and when such figures are calculated the overall "trade picture" between Japan and the United States is less dramatically one-sided.

A third problem concerns the way total bilateral trade between Japan and the United States has expanded tremendously in absolute volume over the past 25 years or so. Within this overall expansion, the United States—not Japan—remains the world's largest exporting nation. Within the context of this expansion, Japan has become an increasingly important market for an even larger total of those U.S. exports. In 1960 Japan received about 6 percent of total U.S. exports; today that figure is nearly double. Japan takes in approximately 20 percent of all U.S. exports, and is the second largest customer for United States exports behind only Canada. In many product areas, Japan is America's best customer. It is, for example, the major market for agricultural exports,

12. E. LINCOLN, JAPAN: FACING ECONOMIC MATURITY 230 (1988).

taking a total equal to more than that of the United States's next three largest export markets (the Soviet Union, the Netherlands, and Canada). For products such as citrus fruits, pork, beef and veal, Japan accepts from 50% to 80% of all U.S. exports.[13]

Still a fourth point concerning bilateral trade figures is that they are not automatically the outgrowth of the presumed guilty party—Japanese protectionism. As Under Secretary of State Allen Wallis noted in 1986, "[t]he [bilateral trade] deficit rose by $13 billion in 1985, but Japan did not erect $13 billion worth of new barriers against our products."[14] In this vein, several studies have revealed that even if all non-tariff barriers in Japan were removed, only about 10% of the total bilateral trade deficit would be eliminated.[15]

Additionally, one must note that the United States, despite its rhetorical commitment to the principles of "free trade" (lately amended to "fair trade"), is by no means without its own massive and increasing protectionist barriers. So-called voluntary export agreements now structure U.S. trade with a number of countries. In recent years, the United States also has added explicit restrictions on the quantity or import prices of beef, mushrooms, motorcycles, textiles, and a host of other products. Some 40% of all U.S. imports are now subject to some form of protectionist controls, a vast increase that took place largely during the Reagan presidency. Among the most egregious examples of U.S. protection is sugar, where the U.S. consumer is forced to pay at least 4 times world market prices due to U.S. import restrictions. While Japanese officials often defend their protection of rice as necessary because rice is an almost religious part of the Japanese diet, a comparable argument about the role of sugar in the American diet has fortunately been absent.

Perhaps most significantly, the bilateral figures conceal what is often a far more complex trade picture based on direct investments in one another's country: the out-sourcing of component products by companies headquartered in one country, but with branches in the other; and most important, profits achieved by such multinational companies. Consider only the following types of examples. Faced with so-called voluntary export restrictions on Japanese automobiles shipped to the United States, Honda Motors, along with a number of other Japa-

---

13. KEIZAI KOHO CENTER, JAPAN: AN INTERNATIONAL COMPARISON, 1987, at 18, 38 (1987).

14. A. Wallis, U.S.-Japan Economic Relations: The Tokyo Summit and Beyond, Address at the U.S.-Japan Economic Agenda Meeting, Washington, D.C. (Apr. 23, 1986), *reprinted in* 826 CURRENT POLICY 1 (1986). *See also*, Wallis, *Economics, Foreign Policy, and United States-Japanese Trade Disputes*, 22 CORNELL INT'L L.J. 381 (1989).

15. C. BERGSTEIN & W. CLINE, THE UNITED STATES-JAPAN ECONOMIC PROBLEM (1985) (estimating that U.S. exports to Japan might increase by $5-8 billion if all Japanese trade barriers were removed and that this would not necessarily affect the trade balance per se). In 1984 and 1985, even U.S. officials announced that if Japan were to remove all of its trade barriers, the bilateral imbalance would shrink by only about $10 billion, or just under one-third of the 1984 imbalance. *Japan and U.S. Nail Down Four Areas in Trade Talks*, Japan Econ. J., Feb. 5, 1985, at 28, col. 1.

nese auto manufacturers, set up American facilities. Leaving aside for a moment the question of whether such cars manufactured in the United States are Japanese or American (let alone just how they benefit different groups of Japanese or Americans), there is now a problem for bilateral trade statistics. Honda has begun exporting cars from its Marysville, Ohio plant to Japan and now has become America's fourth largest auto exporter. Meanwhile, GM, Ford, and Chrysler all have major joint ventures in Japan that involve, among other things, importing products made for them in Japan for assembly in the United States. Technically these appear as "Japanese imports." In a similar vein, IBM and Texas Instruments both source many of their components from their wholly-owned subsidiaries in Japan.[16] Which items, if any, should be considered U.S. exports and which should be Japanese exports? If one decides simply on the basis of which direction across the Pacific a specific item of cargo is headed the answer is clear. If one asks which country's companies benefitted more, the answer is far less obvious.

One thing is certain: a large share of Japanese exports to the United States are in fact structurally tied to American companies rather than being autonomous exports by Japanese companies. Thus, 13% of Japanese exports are parts, largely to U.S. firms; 9% are items not produced in the United States, such as cameras or VCRs marketed here by American retailers; an additional 3% are Japan made items produced for export under the brand names of U.S. distributors such as Sears. Finally, 6% of Japan's exports consist of finished products sent from Japan to the United States by foreign, mostly American, firms. In sum, approximately one-quarter of so-called Japanese exports to the United States are structurally linked to the production and marketing activities of American firms on their home territory.

This bilateral trade problem becomes even more complex when one considers joint ventures between Japanese and American firms, let alone three or four way ventures, as well as the economic implications of the high levels of mutual investment in each other's markets. At one time, the U.S. pharmaceutical giant Merck exported drugs to Japan. In the early 1980s, Merck acquired two Japanese companies, Banyu and Torii, and now ranks among the three largest pharmaceutical companies in Japan. By doing so, Merck has vastly increased its total sales in Japan, even though its actual exports have diminished. Though Merck as a company gained, it did so in a way that worsened the bilateral trade balance for the United States as a whole. How does one interpret the change?

16. "By 1982, for example, Texas Instruments-Japan exported, principally to its parent, one-half of the estimated $300 million worth of memory chips it produced. IBM-Japan, the only IBM subsidiary in the world making XT model disk drives, exported 100 percent of its production to its U.S. parent." Encarnation, *Cross-Investment: A Second Front of Economic Rivalry*, in AMERICA VERSUS JAPAN 141 (T. McCraw ed. 1986). Texas Instruments produces all of the 64 K RAM chips for its worldwide operations in Japan; IBM sources over half of its IBM PC components there. GM, Ford, and Chrysler all have major joint ventures there.

Such direct investments make bilateral trade figures almost meaningless. Most strikingly, one calculation that combined bilateral trade with actual profits by subsidiaries of each nation's companies in the other's markets concluded that there was an almost perfect balance between profits to the U.S. companies and their subsidiaries and profits to the Japanese companies and their subsidiaries, once exports and in-country profits were combined.[17] The rate of return of U.S. foreign direct investment was about 15% in 1987, while that for foreign investment in the U.S. was only 3%.[18] Moreover, sales by U.S. affiliates within Japan are four times larger than Japan's bilateral trade surplus. What this means, simply, is that while merchandise trade between the two countries may be starkly out of balance, the overall economic relationship between the two is far less askew. American companies in the aggregate are selling about as much in Japan as Japanese companies in the aggregate are selling in America. A most important difference is that much of what these American companies are selling is actually produced in Japan as well, whereas the Japanese, with generally lower levels of overseas investment than their American counterparts, are shipping lots of their products across the Pacific.

Thus, if the trade figures properly ignored the sales of American manufacturing firms in Japan back to American parent companies, and properly accounted for sales of U.S. and Japanese companies in one another's markets (rather than just goods that moved between these countries by boat or plane) there would be virtually no bilateral deficit. Phrased differently, Japan would be importing more from America's shores if it did not enjoy direct in-country access to such American products as Schick razor blades, Black & Decker tools, Motorola pagers, IBM computers, Coca Cola, Johnson & Johnson Pampers, and McDonalds burgers.

Add to such complications partial production in each country, plus more regional or multilateral economic links such as production in an export free zone in Hong Kong or the Caribbean, financing by the bank

17. Ohmae, *The Fictitious Japan-U.S. Imbalance*, XIII, 2 JAPAN ECHO 7 (1986). An interesting microcosmic datum supports the same point. *Id.* at 117-18. In 1984, each American spent an average of $243 on Japanese imports plus an additional $44 dollars on "Japanese goods" that involved value added by virtue of Japanese investments for a total of $287 per American. In contrast, each Japanese spent $215 on American imports (significantly below the figure of American purchases of Japanese imports) but an additional $266 on other American goods produced within Japan for a total of $553, nearly twice the amount spent by Americans for "Japanese goods." Encarnation, *supra* note 16, at 117-18. Given the fact that Japan's population is roughly one-half that of the U.S., some overall equanimity is suggested, but even more striking is that the average Japanese buys twice as much American merchandise as his American counterpart buys of Japanese goods.

18. Iwata, U.S.-Japan Economic Relations: A Japanese Perspective (University of Tokyo, Komaba Department of Social and International Relations, Working Paper No. 7, 1988). Studies by the American Chamber of Commerce in Japan suggest similar return levels for U.S. companies doing business in Japan; often the return levels are closer to 18% than 15%.

of still a third country, and one can see how limited a picture of economic realities is created by the simple statistics of bilateral manufactured trade. The most fundamental reality is that a nation's economic well-being and the character of its international economic interactions are at best only partially uncovered in bilateral trade figures. Certainly, the total economic relationship between the world's two largest economies, the United States and Japan, has become vastly more complicated, and by all means far more *integrated* than is conveyed by the bilateral trade figures.

All of this provides a version of statistical overkill designed simply to show a few of the important items that are lost in the microscopic focus on bilateral trade figures alone. Clearly, these points should sustain an argument that there is far more to the economic relationship between the United States and Japan than simple bilateral trade figures convey. The bilateral economic relationship between Japan and the United States is vastly more intricate, convoluted, and reciprocal than that single figure implies. This bilateral economic relationship is complicated even further by the regional and international relationships which surround and include it.

Yet macroeconomics aside, there are two fundamental realities concealed within the bilateral trade numbers that provide the political propulsion that keep it so vividly before the American public. Both of these are political in nature. First, there has been a very real shift in the international balance of power, a central component of which is the *relative* economic decline of the Unites States. Second, there are many important political constituencies in the United States which are screaming very loudly about the impact of Japanese imports on them and their economic fortunes, while different but similarly important constituencies are equally vocal in demanding official help in their efforts to gain some share of the extensive and lucrative Japanese domestic market. These two political points lie at the heart of the political importance given to the economic debates about the bilateral trade relationship.

II. The Politics of Bilateral Trade

For the political scientist looking at the current disputes concerning U.S.-Japan trade, as well as the broader economic relations between the two countries, two points are particularly critical. First, as has been widely noted, the yawning bilateral trade deficit with Japan is but a part of America's much more substantial trade deficit with all areas of the world. The U.S. trade gap with Japan (as well as with Asia's newly industrialized countries) is only one component of a much larger shrinking of the U.S. trade position throughout the world. The United States enjoyed a positive balance of trade from 1893 until 1971. Since the middle of the 1970s, however, the overall balance of trade for the U.S. has become increasingly negative; since the early 1980s, the United States has had an unfavorable balance of trade with every single region of the world, including Latin America and Western Europe, once the recipients of a vastly greater share of U.S. products than these regions sold to America. This shift has been exceptionally rapid and geometric; indeed the trade imbalance during most *months* of 1988 was more than one and a half times larger than the entire *annual* imbalance in 1976.

The United States' share of overall world trade has declined rather substantially and steadily since the 1950s. In 1950, the United States supplied 20% of total world exports, 30% of world manufactures and 50% or more of many capital goods and other manufactured products. Its huge surpluses allowed it to accumulate $24 billion in international reserves (32% of the world total). By the early 1980s, that share was only about 13-15% of the world's total exports, and as little as 13% of the world's manufactured exports.[19] Japanese companies were among the most successful in capturing markets lost by U.S. companies both in this country and abroad. Yet, the Japanese balance, even though equal to one-fourth to one-third of the current U.S. total imbalance, is by no means unusual within the context of the overall decline suffered by the United States in its total trade.[20] It is far less the cause, and far more the consequence, of an overall structural decline in U.S. export competitiveness throughout the world, particularly in manufactured goods.

Part of this overall decline is the logical and inevitable outgrowth of the extremely distorted production and trade advantages the United States enjoyed at the end of World War II. The United States was virtually the world's only industrialized country to emerge from the war with a higher index of industrial production than when the war began. Almost all of Western Europe as well as Japan saw their industrial infrastructures decimated by the war. In contrast, the United States emerged with a substantially stronger industrial and manufacturing base, having undergone "total mobilization" for the war, but never suffering the losses associated with having itself been a battlefield.[21]

This did at least two important things. First, it artificially inflated the worldwide economic dominance of the U.S. and its firms. Second, it induced a false sense of international economic superiority throughout American government and business. Without competition, worldwide

19. Yoffie, *Protecting World Markets*, in AMERICA VERSUS JAPAN 51 (T. McCraw ed. 1986).

20. A number of scholars have examined this point, but among the more compelling works are R. ROSECRANCE, THE RISE OF THE TRADING STATE: COMMERCE AND CONQUEST IN THE MODERN WORLD (1986); U.S. COMPETITIVENESS IN THE WORLD ECONOMY (B. Scott & G. Lodge eds. 1985); R. GILPIN, THE POLITICAL ECONOMY OF INTERNATIONAL RELATIONS (1987), see ch. 5; and R. KEOHANE, AFTER HEGEMONY: COOPERATION AND DISCORD IN THE WORLD POLITICAL ECONOMY (1984).

21. Comparing the major countries' indices of industrial production, only Sweden (which was neutral in the war) and Britain came out of the war "ahead" of where they had been industrially in the late 1930s. In both cases, their improvements were marginal. The U.S., in contrast, emerged with a production index approximately 75% higher than that of 1938. *See, e.g.*, P. ARMSTRONG, A. GLYN & J. HARRISON, CAPITALISM SINCE WORLD WAR II, THE MAKING AND BREAKUP OF THE GREAT BOOM, chs. 2 and 4 (1984).

business was easy for American companies. For most American companies, their only serious challengers were other U.S. firms. Together American companies enjoyed such phenomenal technological advantages over most of their foreign competitors that virtually any citizen of the world who wished to buy any manufactured item could choose only from among American produced goods. Numerous industrial sectors in the U.S. evolved into relatively stable oligopolies with only marginally increasing demand and high barriers to entry.[22] For many American companies, this induced the unfortunately anti-competitive presumption that their short-run good fortune was somehow the result of an inherently superior competitiveness. Many proved far less invulnerable once the economies of Japan, France, Italy, West Germany and others regained economic momentum, and companies from these countries began competing effectively for market shares previously held by their American rivals by default.

At the same time, logical as some decline in relative shares of world trade would appear to have been for the United States, given the artificiality of its large share in the 1950s and early 1960s, the recent and widespread decline in U.S. shares of world trade goes beyond a mere righting of some drastically overswung pendulum. Over and above any such natural reduction in world trade shares, an even more real decline has occurred in the relative economic position of this country within world markets. This decline is measurable not only in trade figures, but also in the relative value of the dollar, in relative growth of gross national product, in foreign reserves, and most dramatically in the nation's current account balance.

In assessing this problem of national decline, it is important to recognize the naturalness of some form of recalibration, and hence not to overstate the case. Too easily, Japan's real economic gains are taken as a mistaken sign that it has become the world's most successful economy.[23] In fact, the U.S. is still the world's largest economy by far; its overall productivity remains the highest in the world (even as it improves less quickly than that of many of its competitors); it remains the world's largest trader; many of its specific industries and particular products are far and away the highest in quality and the most competitive in price in the world.

At the same time, just as it is important not to overreact to the relative decline in U.S. economic hegemony, complacency about either American superiority or the Japanese challenge to it would be an even greater folly. With characteristic candor and insight, Ron Dore, in writ-

22. C. JOHNSON, L. D'ANDREA TYSON & J. ZYSMAN, POLITICS AND PRODUCTIVITY: THE REAL STORY OF WHY JAPAN WORKS 43 (1989).

23. Though an admirable book in many ways, this is certainly a criticism that could be leveled at E. VOGEL, JAPAN AS NUMBER 1: LESSONS FOR AMERICA (1979). A subsequent and more balanced treatment of the relative economic positions is U.S. COMPETITIVENESS IN THE WORLD ECONOMY (B. Scott & G. Lodge eds. 1984). *See also* U.S. DEPARTMENT OF COMMERCE, AN ASSESSMENT OF U.S. COMPETITIVENESS IN HIGH TECHNOLOGY INDUSTRIES (1983); AMERICA VERSUS JAPAN (T. McCraw ed. 1986).

ing about the British response to Japanese economic success, sums up widespread reaction:

> To the complacent ones on the Left, Japan is a harsh and oppressive society whose competitive success rests on exploitation of low-paid workers. For the complacent ones on the Right . . . well, they're a lot of little swots, aren't they? Good imitators. No humor, no originality. It's hard to take them seriously.[24]

Such a supercilious dismissal of Japan by Americans would only result in this country's economy becoming even more dismally akin to that of Britain's.

In reality, over the past three decades or so, Japan, along with several other countries, has politically and economically been structured to improve its overall international economic competitiveness. Many of these countries have been deliberately structured as what Chalmers Johnson has labelled "capitalist developmental states."[25] Over the last two decades, there has been a dramatic shift in the world's center of economic gravity towards such states, representing a quantum transfer of economic muscle from the Atlantic to the Pacific.[26] It is this shift, and the conditions behind it, that must be given the most serious attention in the United States; bilateral trade gaps are but its most tangible manifestation.

This qualitative shift in the world's economic balance then is the first political item that must be addressed within the U.S. by political and economic leaders, for this basic fact of political economy lies at the heart of the current economic disputes between Japan and the United States. Failure to recognize these deep-seated causes of the current trade dispute will compel the U.S., like history's unsuccessful generals, to continue fighting the last, rather than the current, war.

There is a second political observation regarding the current trade disputes. For the political scientist concerned with costs and benefits to specific socio-economic groups, rather than for the economist concerned with macro-level economic balances, it is important to stress that the economic actors within any country facing a negative trade balance rarely "suffer" equally. Nor do all segments of a country enjoying a pos-

---

24. R. Dore, Taking Japan Seriously 3 (1987).

25. Johnson's earliest formulation of this concept was in C. Johnson, MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975 (1982). He subsequently expanded on the territorial applicability of the concept to include many of the Asian newly industrialized countries in Johnson, *The Nonsocialist NICs: East Asia*, 40 Int'l Org. 557 (1986). *See also* F. Deyo, The Political Economy of the New Asian Industrialism (1987).

26. According to a study by the Nomura Research Institute, for the two decades 1960-80, neither Japan nor any of the newly industrialized Asian countries ever fell below an average growth rate of 8.5% per year. By contrast, the U.S. as a whole, OECD Europe, and the less-developed non-Asian countries hovered around 2.5-3.0%, except for the huge American surge in 1984. Johnson, *The Pacific Basin's Challenge to America: Myth and Reality*, USA Today, Mar. 1987, at 22. Total U.S. trade across the Pacific is now well ahead of that across the Atlantic.

itive trade balance benefit equally. A nation's overall trade balances, both cumulative and bilateral, mask a wide array of plus and minus signs. Thus, many of a nation's industries may confront lower profits in the face of import competition within their product areas, but that same nation's consumers typically benefit from lower prices, a broader spectrum of choice and often higher quality in the goods they buy. Low cost imports of industrial or raw materials appear a threat to some, but certainly not to the manufacturers who use them to reduce their costs or to increase the profitability of their final products. Nor are there typically many complaints from workers in industries whose jobs become better paying and more secure as a result of stable and low cost inputs for the items they make. Import industries tend to view certain trade "problems" quite differently from their exporting counterparts. Meanwhile, sellers of shipping insurance can benefit equally from trade going either into or out of a country, regardless of what happens to the total, or to bilateral, trade balances. So too do the bankers who finance the trade or the harbormasters or airport managers who can move goods in either direction.

The most salient political fact is that overall figures mean nothing to those whose individual calculations convince them that they have been hurt. To those who are negatively affected, it is little consolation to know that their loss has been statistically offset by someone else's success. The worker who has lost a job in a steel plant finds little joy in the knowledge that elsewhere telecommunications is booming. A failing plastics firm in a small Ohio town is no less a disaster for its bankrupt owner, its laid off workers, and the local economy if 2000 miles away, but operating within the same system of national accounts, a fiber optics plant in southern California has a gloriously favorable balance sheet.

This point is essential to understanding a large measure of the heat generated in the U.S. over the current bilateral trade balances, as well as the overall economic competition between Japan and the United States. Essentially, the political and economic institutions of Japan, complex and inefficient as they may often appear to insiders and students of Japanese policy-making, are, in fact, quite well adapted toward making Japan's economy more internationally competitive.[27] In the U.S., by way of contrast, the dominant political and economic philosophies are based on separation of institutions, and competition among them. In terms of international economics, these institutions are very rarely structured to improve the international competitiveness of American firms or American products in any categorical way. Since the formation of the

27. Among the more detailed studies of Japanese policymaking that explore some of the intricacies of intra-agency and interest group battling, especially as they affect trade related issues, are I. DESTLER, H. FUKUI & H. SATO, THE TEXTILE WRANGLE: CONFLICT IN JAPANESE-AMERICAN RELATIONS (1979); I. DESTLER & H. SATO, COPING WITH U.S.-JAPANESE ECONOMIC CONFLICTS (1982); N. MINORU, NIHONGATA SEISAKU KETTEI NO HENYO (1986). *See also* Pempel, *The Unbundling of 'Japan, Inc.:' The Changing Dynamics of Japanese Policy Formation*, 13 J. OF JAPANESE STUD. 271 (1987).

Constitution, and as articulated in the Federalist Papers, American political institutions have been predicated on the system of checks and balances. Congress in particular, and the House of Representatives more especially, is structurally designed to protect and advance local rather than national constituency interests. Most of America's antitrust policy was formulated to protect U.S. consumers from rapacious robber barons, not to enhance the competitiveness of American products in the international marketplace.

Certainly a large number of American firms have moved aggressively into the international arena and have done exceptionally well. But at the same time, vastly greater numbers have focused their attentions on local or national markets only. When confronted by superior competition by foreign products, most find automatic allies within the political system anxious to "protect" them from such "unfair competition" (rather, for example, than protecting consumers from "protectionism"). The U.S. has the industrial world's lowest ratio of exports to GNP (5.3%), as well as the world's lowest ratio of imports to GNP (9.1%). By way of contrast, imports represent 10% of Japan's GNP, and exports represent 13%. Most of the countries of Western Europe, with their substantially more integrated markets, have both ratios in the 20-30% range.[28]

Even more striking is the fact that America's largest companies, internationalist as both they and we may see them, are still far less export-oriented than their Japanese (or European) counterparts. McCraw presents a revealing comparison of the top ten exporters of manufactured goods in the U.S. and Japan.[29] Exports as a percent of total sales for the Japanese firms range from a low of 29% to a high of 71%, with an average of 48% (my calculations). The American companies range from 7% to 35%, with an average of 15%. If America's largest and most export conscious firms lag so far behind their Japanese counterparts in their export orientation, how much more striking must be the figures for smaller American firms?

The American market has long been the largest in the world. For many American manufacturers, that was a sufficiently large pie over which to fight. But now two things have happened. First, foreign firms have also entered the American market to challenge what was once a national monopoly on market share, and second, a large number of foreign markets have become so economically vast that they are ignored by an American company only at peril to its own long term competitiveness.

The Japanese government, and Japanese firms, have long behaved as if the ultimate marketplace was international in character. Both have been structured to succeed in such markets. Even small and medium

28. Based on figures in KEIZAI KOHO CENTER, *supra* note 13, at 31.

29. McCraw, *From Partners to Competitors: An Overview of the Period Since World War II*, in AMERICA VERSUS JAPAN 31 (T. McCraw ed. 1986).

sized Japanese companies know that their ultimate marketplace is the world at large. The American government and many American firms are only beginning to learn that basic lesson.[30] In the meantime, the institutionalization of a predisposition toward protection of jobs and industries is far greater in the U.S. than in Japan.[31]

These two political points must be kept in mind in any discussion of the economic relations between Japan and the United States, as well as any proposal for changes that might take place in that relationship in the 1990s.

III. Looking Toward the 1990s

The relationship between Japan and the United States is one of the most important, and heretofore has been one of the most cooperative and compatible, in the world. It is important when looking at current economic disputes to keep that fact in mind, and to build toward cooperation rather than competition. Only on such a basis can one begin making serious suggestions about the next decade.

Equally important is for participants within both countries to begin to recognize that many of the differences between their two political and economic systems are, in fact, structural. They are unlikely to go away easily. The two countries, quite frankly, are rather different in many important respects. Loud as Japanese government officials may call for "internationalization," there are bound to be a large number of petty (and not so petty) officials and business people who will still behave as xenophobes in their daily behavior—whether on the basis of claims about the un-Japanese noises made by imported baseball bats, or on chauvinistic assumptions that American cultural diversity will undercut America's ability to produce skilled blue collar workers. Japan's *keiretsu*, trade associations and information gathering networks, will not be dissolved; its product distribution networks are likely to remain highly convoluted and intensely loyal to parent firms; the Ministry of Finance will continue to seek overbalanced budgets; Japanese bureaucrats are still far more likely to be educated in public administration at Tokyo University than in Keynesianism at the Kennedy School; Japanese stock brokers will undoubtedly continue to give inside tips to important politicians.

In a similar vein, America will almost certainly always have more Congressional officials inclined to seek votes at home by blaming foreign competition than supra-partisan "statesmen" willing to sacrifice their political careers to an assessment of specific political issues in

30. Interesting analysis along these lines is presented in BETWEEN POWER AND PLENTY: FOREIGN ECONOMIC POLICIES OF ADVANCED INDUSTRIAL STATES (P. Katzenstein ed. 1977). See especially the Introduction and Conclusion by Katzenstein, as well as the chapter on the United States by Krasner and that on Japan by Pempel.

31. This is by no means to suggest that Japan lacks protectionism. Nevertheless, the country also appears better structured to phase out its internationally less competitive industries than the United States. *See, e.g.*, Boyer, *How Japan Manages Declining Industries*, FORTUNE, Jan. 10, 1983, at 58.

terms of world history, national interest, or international trade theory. Many American business leaders will undoubtedly die with their eyes fixed firmly and fondly on the altar of "The Market." Most top American officials will be chosen for their political connections rather than for their educational backgrounds or their policy expertise. The American predisposition toward lawyers, courts and "legal" solutions is unlikely to vanish in the near term.

Such broad structural traits must be mutually recognized and accepted as relatively inherent parts of each country's history and tradition. They contribute to many aspects of each country's approach to world trade and are not likely to change dramatically in the near term.

Yet, at the present time, considerable political energy in the United States is being directed at forcing Japan to change many of its structural traits, on the claim that they constitute unfair trade barriers. Equally probable of success would be demands from Japanese counterparts for a "more rational" U.S. legislature or an end to leveraged buy-outs.

Recent demands for sector-by-sector management of U.S.-Japan trade or for automatic annual reductions in the bilateral trade imbalance are equally impractical, and even more harmful to America's long run economic well-being. Such actions would only freeze in place the uncompetitive world character of many American industries, leaving them vastly more vulnerable to competition in the long run.[32] Moreover, they would make it that much easier politically to avoid the long-run structural adjustments in the American economy that are essential to ensure long-term, market compatible, economic vigor in key manufacturing areas.

The trade imbalance must be recognized as having a number of deep structural causes that go far beyond trade *per se*. Solutions to such structural problems will require steps that themselves are structural in character. Consequently, there is not likely to be any quick short-run solution.

At the same time, steps can be taken by both countries within the context of their existing systems that will begin to improve bilateral relations almost immediately. Most importantly, such steps, would be congruent with the kinds of long term, market-compatible adjustments that will enhance their own long term economic prospects as well. Comments on such a subject must necessarily be perfunctory given time and space limitations, but in bullet form one should be able to get ready agreement on several things. On the Japanese side, Japan must:

— continue to liberalize its economy and most especially its imports;[33]

32. It is worth remembering that Japan's so-called voluntary export restrictions on automobiles were designed to give American manufacturers a chance to become internationally competitive. For at least several years, most chose simply to raise prices and profits, rather than invest in restructuring.

33. One of the less well known facts about Japan is just how rapidly it has increased its imports. Between 1985 and 1988, Japanese imports increased 37%, the largest figure in the industrialized world. THE ECONOMIST, Jan. 7-13, 1989, at 92.

— make a more serious determination about just how it will recirculate the money from its trade surplus. Thus far, much has gone into financing the U.S. debt; far more long term attention must be given to how it could be used to help reduce excessive U.S. military spending;
— become more sensitive to local American constituent politics in its trade and investment policies, as many companies have tried to do in the past, rather than focusing simply on macro-economic suggestions for America's "improvement."

The bulk of the adjustment, however, must come on the American side. In effect, the U.S. must begin a systematic effort to become sensitive to the world market place, and to make some serious adjustments to improve America's long term competitiveness. Again in bullet form, the U.S. must, among other things:

— begin to deal with the budget deficit; so much has been said about this problem that it hardly bears repeating, but until some greater balance is reached, the American standard of living will continue to decline in relative terms, and the trade and financial problems the country faces will continue to mount;
— begin to think more systematically, both in government and in companies, about long term markets;
— increase investment and savings;[34]
— put more effort into the training of *civilian* engineers and technicians. Currently Japan graduates three times more engineers per capita than the U.S.; most in Japan work in the civilian industries; most in the U.S. are in defense areas;
— refocus on the infrastructure behind a successful economy. This means lowering crime rates, increasing educational levels, rebuilding roads and tunnels and the like. A world class economy can not be based exclusively on managerial expertise;
— develop increased international sensitivity. The U.S. has been highly conscious politically of world developments in the military and security areas; it has been far less so in international economic areas. This balance must be shifted. In particular, American business leaders must realize that just because it is good enough for Peoria does not mean it is good enough for the rest of the world. Even more importantly, Americans anxious to sell abroad must relearn the basic truism that the languages of business are those of the consumer. Until Americans begin learning foreign languages, in greater numbers, they are unlikely to outsell those who at least make the effort to learn the language of the country in which they are doing business.[35]

34. Gross fixed investment in Japan remains about twice the level in the United States, and the costs of capital in Japan are about one-half that in the United States.

35. A well-quoted statistic that is now surely a bit dated, but probably only in absolute terms, not in proportions, is that there were 8,000 American business people in Japan vs. 100,000 Japanese in the United States. Virtually all of the Japanese spoke at least some passing version of English, while probably fewer than 200 of the Americans spoke Japanese at a comparable level. At the same time, it is worth noting that just as Japanese imports have increased substantially, so have American exports, up 51% from 1985-88, again the largest increase in the industrialized world. THE ECONOMIST, Jan. 7-13, 1989, at 92.

The apparent simplicity of such proposals might make them appear beyond challenge to an academic audience. Yet each will require a good deal of political, economic, and more importantly psychological readjustment. As such they are unlikely to win easy support from those concerned with day-to-day decision making and momentary crises (such as monthly trade figures). Consequently, they will not be easy to achieve. But until such changes are begun, and most particularly, until a far broader swath of Americans becomes more international in focus, it is probable that one will continue to see the monthly focus on the bilateral trade figures. And one will undoubtedly see the continued reiteration of all of the well-known positions taken on both sides of the issue. Yet so long as the focus remains on that non-problem, the deeper problems will continue to be skirted.