

# Federal Reserve Bank of San Francisco

September 24, 1982

## Japan's Trade Surplus

The size of the Japanese trade surplus with the United States and the European Economic Community (EEC) has seriously impaired trade relations among the three major trading partners. It has led to a growing debate over the effects of trade imbalances on domestic economies. Some policymakers in the U.S. and the EEC have blamed their trade deficits for widespread domestic recession and unemployment, while others believe that their economic malaise is not a consequence of foreign competition but a reflection of structural problems in Western economies.

Which side is correct in this debate? Last year, the Japanese trade surplus with the EEC reached \$10.3 billion compared with \$8.8 billion in 1980, and the U.S. bilateral trade deficit with Japan registered \$13.4 billion, nearly double the 1980 shortfall of \$7 billion. Projections by the international Organization for Economic Co-operation and Development indicate this trend will continue through 1983.

The critics who blame Japan are calling for voluntary restraints on Japanese exports or the imposition of import quotas in their countries. Other analysts argue that the Western economies would be better off emulating Japan's performance by restoring the cost competitiveness of their industries. They stress that import or export quotas serve only as short-term palliatives that temporarily shelter inefficient industries from the rigors of competition.

An examination of the economic factors responsible for the large and growing trade surplus can be a valuable aid to our understanding of this issue. It will also provide a basis for analyzing the implications of future economic policy in this area. Below, we focus on Japan's export performance as a means of highlighting what we consider the most significant aspects of the situation.

### Cost competitiveness

Commentators often note that because Japan devotes a higher proportion of its output to investment than any other major industrialized country, it has had a much higher growth in labor productivity. They claim these increases in output per manhour have improved the cost competitiveness of Japanese products in world markets. For example, from 1975 onward, labor productivity growth averaged 7.6 percent in Japan, 3.2 percent in the U.S., and 3.7 percent in the EEC. Furthermore, this higher labor productivity growth, and its beneficial impact on competitiveness, was not offset by higher nominal wage settlements by Japanese workers, unlike their American and European counterparts. As a result, labor costs per unit of manufacturing output have remained virtually unchanged in Japan since 1975, while they have increased at an average annual rate of 7.8 percent in the U.S. and 11.4 percent in the EEC.

Japan's successful containment of labor costs would seem to provide a cogent explanation for its expanding trade surplus. But these costs are measured in domestic currency units. Adjusting for exchange rate changes shows that Japan's cost competitiveness was actually deteriorating through the third quarter of 1978 (see chart). However, from that point on, the yen exchange rate—far from compensating for international differences in unit labor costs—has depreciated sharply against the U.S. dollar. The drop in the yen's exchange rate, most notably in the last four quarters, has dramatically bolstered Japan's competitive position in world markets.

### Exchange rates and oil prices

The reversal of the upward trend in the yen rate can, in part, be ascribed to a coincident run-up in oil prices. Because oil represents 40 percent of the Japanese import bill, the sharp rise in oil prices in the late 1970's greatly enlarged Japan's import costs. As a result, the yen exchange rate depreciated and improved

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the price competitiveness of Japanese goods. The depreciation thereby created the foreign demand for a greater quantity of Japanese exports. The increased exports found their way into the U.S. and EEC markets and thus raised Japan's market share during the period of widespread recession and unemployment.

On a trade-weighted basis, the yen depreciated 21.4 percent between the second half of 1978 and the first half of 1980. This drop, resulting in part from oil price hikes, contributed to a 32.4 percent gain in Japanese cost competitiveness in the same period as relative unit labor costs also moved in Japan's favor. The improvement in Japan's cost competitiveness led to a fall in the dollar price of Japanese manufactured goods relative to foreign competitors of 13.6 percent between 1978 and 1980. This improvement in Japan's price competitiveness can largely account for the 26.5 percent growth in export volume between 1979 and 1981. Because of this exceptionally strong export volume growth, the total trade account of Japan moved from a deficit of \$9.3 billion in the first half of 1980 to a surplus of \$8.9 billion for the year 1981 as a whole.

### **Fiscal and monetary policies**

More recently, the yen exchange rate has continued to decline against the dollar despite the fall in energy prices. This apparent paradox has been attributed by many observers to the different mix of monetary and fiscal policies instituted in the two countries. Japanese officials believe Washington's economic policy involving big budget deficits and monetary restraint has produced abnormally high real interest rates that have dramatically bolstered the dollar's value in the foreign exchange markets. They therefore feel that the dollar's strong performance against the yen is due entirely to U.S. macroeconomic policy.

Japanese macroeconomic policy, however, has not been blameless in the depreciation of the yen. The Japanese government's monetary and fiscal policy mix brought about a

three percentage point decline in Japanese short-term interest rates between December 1980 and August 1982. The reduced yields coupled with a liberalization of capital controls in December 1980 increased the attractiveness of dollar denominated investments to Japanese residents, prompting capital outflows and a weak yen. Thus, the evidence implies that fiscal and monetary policies of both countries are responsible for the depreciating yen and the resulting decline in U.S. price competitiveness.

The conflict between U.S. and Japan over trade matters surfaced once before back in 1977-78. At that time, the U.S. advocated that West Germany and Japan, two countries with large trade and current account surpluses, should inject fiscal stimuli to expand their economies. The resulting faster economic growth would produce a higher level of imports, which, in turn, would reduce the trade and current account surpluses. Because the current account balance represents the amount of private savings left over after deducting the public sector deficit and private investment, a higher public sector deficit with unchanged private savings and investment would, by definition, produce a commensurate fall in the current account surplus. Thus, Japan could cut its projected surpluses on current account by increasing its fiscal deficit through higher public spending or lower taxes.

In 1977 and 1978, Japan's economic environment was receptive to this course of action. The yen exchange rate was appreciating markedly, creating slack economic conditions. A stimulatory fiscal policy would have posed no policy dilemma for Japan on domestic grounds; it would have complemented the appreciating exchange rate in bringing about a lower current account surplus.

The present economic environment in Japan is not too dissimilar. While the yen exchange rate has been depreciating against the dollar, economic activity has stagnated, in part

because of a slowdown in export volume growth due to voluntary restraints on shipments to Western Europe. Because real economic activity in Japan is slowing, there is room for fiscal stimulus. The government, however, is adverse to do so because of already large fiscal deficits which have averaged between 4 and 5 percent of GNP in the 1978-1981 period, considerably higher than those of the U.S. In fact, Japan's medium term strategy calls for reducing the growth of public spending to bring the budget back into balance by fiscal 1984/85.

Further compounding the trade imbalance problem are the high and possibly growing budget deficits projected for the U.S. in the foreseeable future. A move toward fiscal restraint would improve the U.S. trade picture, but the fiscal policies presently adopted by the U.S. and Japan, are likely to exacerbate the current account problems of the two countries and further the trend towards protectionism.

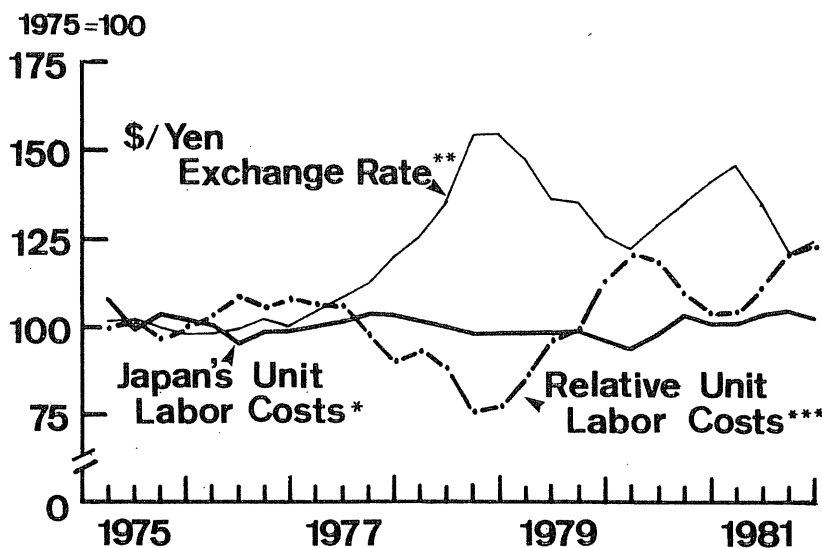
### What to do?

Contrary to popular opinion, Japan's expanding trade surplus against the U.S. is not a product of lower labor cost increases and related productivity gains of Japanese workers. Until the runup in oil prices, movements of the yen rate more than compensated for any cost advantage when Japan's labor costs were rising more slowly than those of the U.S. It was the fall in the yen's value, resulting, in part, from oil price hikes, that contributed greatly to the expansion of Japan's bilateral trade surplus with the U.S.

More recently, the different mix of monetary and fiscal policies implemented in the two countries has added to the trade imbalance. The move towards fiscal expansion in the U.S. and fiscal restraint in Japan has exacerbated the trade and current account imbalances between the two countries. And it is this misalignment of fiscal actions, rather than a long-run decline in U.S. labor productivity, that has contributed to Japan's expanding trade surplus.

Kenneth Bernauer and David Parsley

## COST COMPETITIVENESS



\*Measured in yen

\*\*U.S. cents per yen

\*\*\*U.S. unit labor costs relative to Japan (measured in dollars)

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**BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT**

(Dollar amounts in millions)

Selected Assets and Liabilities	Amount	Change	Change from	
	Outstanding 9/8/82	from 9/1/82	Dollar	Percent
<b>Large Commercial Banks</b>				
Loans (gross, adjusted) and investments*	161,362	- 62	9,309	6.1
Loans (gross, adjusted) — total#	141,462	- 79	10,419	8.0
Commercial and industrial	45,124	225	5,644	14.3
Real estate	57,454	13	3,189	5.9
Loans to individuals	23,509	- 54	485	2.1
Securities loans	2,379	- 47	1,015	74.4
U.S. Treasury securities*	6,466	132	708	12.3
Other securities*	13,434	- 115	- 1,818	- 11.9
Demand deposits — total#	41,775	- 83	- 2,246	- 5.1
Demand deposits — adjusted	27,983	- 464	- 1,849	- 6.2
Savings deposits — total	31,648	427	1,516	5.0
Time deposits — total#	99,176	83	13,126	15.3
Individuals, part. & corp.	89,379	- 111	11,537	14.8
(Large negotiable CD's)	37,099	- 164	2,172	6.2
<b>Weekly Averages of Daily Figures</b>	Week ended 9/8/82	Week ended 9/1/82	Comparable year-ago period	
<b>Member Bank Reserve Position</b>				
Excess Reserves (+)/Deficiency (-)	149	606	118	
Borrowings	14	6	331	
Net free reserves (+)/Net borrowed(-)	135	600	- 213	

\* Excludes trading account securities.

# Includes items not shown separately.

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