

# **U.S. — JAPAN TRADE TENSION**

## **PART 1**

### **WHAT IS AT FAULT?**

#### **INTRODUCTION**

The U.S. merchandise trade deficit last year reached \$123 billion, including a \$37 billion deficit with Japan. This year the U.S. global trade deficit is likely to hit \$150 billion, with a \$45 billion deficit with Japan. The U.S.-Japanese trade gap has provoked strong emotional reactions in Congress and a torrent of protectionist proposals. The trouble is that these proposals would be very costly to the U.S. economy, consumers, and workers.

Concern over the trade deficit with Japan is in part a reaction to its overall size. There is widespread confusion, however, about the actual meaning of the trade statistics. A merchandise trade deficit as such is not necessarily a problem--a net inflow of goods often accompanies a country's economic expansion. A merchandise deficit, moreover, typically is offset by other factors such as revenues paid by foreigners for banking, insurance, and other services. The "current accounts balance" is a truer reflection of a nation's performance in the world marketplace. It includes service trade and interest income earned abroad. Even though the U.S. is now running a current accounts deficit, such a deficit cannot be maintained indefinitely, and the market will adjust on its own with a lower dollar. Further, the current accounts balance ignores inflows of foreign capital, some of which goes to business investments, creating jobs for Americans. The raw figures, in short, mask a complex situation involving many benefits as well as costs.

The U.S. trade deficit is not primarily the result of Japanese trade restrictions. Studies indicate that, if all Japanese restrictions were lifted, the trade gap would be cut initially by

no more than \$10 billion a year, and perhaps by as little as \$6 to \$8 billion. Yet the U.S.-Japan trade relationship is nonetheless central to the deficit debate. For one thing, both nations are economic megapowers. For another, both typify the highest technology, most competitive marketplace, and most creative entrepreneurs in the world. If Tokyo and Washington get locked into a trade war, it will symbolize the collapse of the post-World War II era of liberalized trade and could trigger a global economic slowdown, even a depression.

To defuse the particularly explosive trade situation, steps by both Tokyo and Washington are needed. The U.S. government, for instance, imposes restrictions on U.S. exports, while many U.S. business practices also impede exports. In particular, U.S. businessmen often pay too little attention to the needs and customs of foreign clients. And Tokyo does in fact limit the access of a number of U.S. products and services to the Japanese market, such as beef, citrus, paper products, and telecommunications equipment. If both sides took action in such matters, a freer flow of trade would benefit the citizens of each country.

#### AN ANATOMY OF U.S.-JAPAN TRADE

The furor against Japan has been triggered by a number of factors. First, there is a general perception that, while the U.S. maintains relatively open markets, Japan erects numerous trade barriers against U.S. goods. Second, when in April 1985, Japan sold its massive state telecommunications monopoly to the private sector, U.S. policy makers felt that the guidelines for large purchases of new equipment shut out U.S. firms. Third, when Ronald Reagan lifted quota restrictions on Japanese autos, many Congressmen felt that Tokyo did not take commensurate measures to open up Japanese markets. Finally, the merchandise trade deficit is assumed by many Congressmen to imply a structural economic imbalance in need of immediate U.S. government remedies.

Elements of truth and error are entwined in these views. The challenge to U.S. and Japanese policy makers is to separate the legitimate problems from the distortions.

U.S.-Japanese trade relations should be examined in the context of both countries' economies. As Table 1 indicates, the U.S. gross national product is about three times that of Japan. With twice the population of Japan, the U.S. per capita income is about 50 percent higher than the Japanese. International trade is much more important to Japan than to the U.S.; merchandise exports plus imports alone amount to 25 percent of Japan's GNP compared with approximately 15 percent for the U.S.

In addition, the U.S. boasts major deposits of oil, coal, and natural gas, whereas Japan must import nearly all of its energy. The U.S. is a huge, fertile land, which is not only self-sufficient in food but can export much of its crop. Japan, at only 4 percent the size of the U.S., is mainly mountainous, uncultivated, and sparsely populated. Where it is populated, density is near the world's highest.

Table 1

<u>Approximate 1984 figures</u>	<u>U.S.</u>	<u>Japan</u>
GNP	\$ 3.7 trillion	\$ 1.2 trillion
Population	236.6 million	120 million
Per capita income	\$15,500	\$10,000
Exports plus imports as GNP percentage	15%	25%
GNP Growth	6.9%	5.8%

Source: International Financial Statistics, July 1985, International Monetary Fund, Washington, D.C.

### The Course of U.S.-Japan Trade

The U.S. merchandise trade balance, reflecting the difference between the value of manufactured goods imported and exported, ran an average \$4 billion annual surplus in the 25 years after the Second World War (see Table 2). Since 1970, the U.S. generally has imported more merchandise than it has exported. The merchandise deficit averaged \$39 billion between 1977 and 1982, widened to \$69.3 billion in 1983, and hit \$123 billion last year. This year the merchandise trade deficit could reach \$150 billion.

Table 2  
U.S.-Japan Merchandise Trade (in \$ billions)

	1946-1970 average	1971-1976 average	1977-1981 average	1983	1984
Exports	20.3	80.7	181.8	\$200.5	\$217.9
Imports	16.3	83.0	210.9	\$269.9	\$341.2
Merchandise trade balance	+\$4.0	-\$2.3	-\$29.1	-\$69.4	-\$123.3

Source: Economic Report of the President, February 1985; Council of Economic Advisers; Economic Indicators, various 1985 issues, Council of Economic Advisers, for the Joint Economic Committee.

America's top trading partner is Canada, followed by Japan (see Table 3). Although the U.S. runs a merchandise trade deficit with both Canada and Japan, the trade deficit with Japan is the larger. However, the per capita U.S. trade deficit for Canada's 25 million inhabitants was \$816 in 1984, compared to \$308 for

Table 3

Canada (in \$ billions)	1983	1984	Japan (in \$ billions)	1983	1984
U.S. Imports	\$52.5	\$66.9	U.S. Imports	\$43.6	\$60.4
U.S. Exports	\$38.2	\$46.5	U.S. Exports	\$21.9	\$23.6
Balance	-\$14.3	-\$20.3	Balance	-\$21.7	-\$36.8

Source: United States Trade: Performance in 1984 and Outlook, U.S. Department of Commerce, International Trade Administration.

Japan. The primary U.S. exports to Japan are manufactured goods, valued at nearly \$12 billion, and agricultural products, valued at some \$7 billion. Japan is America's largest customer for beef, pork, chicken, and various citrus fruits, and its second largest market for wheat and soybeans.<sup>1</sup> The primary U.S. imports from Japan include automobiles, some \$13 to \$14 billion worth, and other manufactured goods such as telecommunications equipment and computer chips.

With annual GNP growth rates running as high as 10 percent during the 1950s and 1960s, Japan generally ran merchandise trade deficits. This is typical for expanding economies, which suck in imported goods to meet growing domestic demands. Again typically, as Japan's growth slowed in the 1970s, Japan moved into surplus--though as recently as 1979 the merchandise surplus was only \$1.85 billion. In 1984, it reached \$44.4 billion.

Merchandise trade figures, of course, do not include trade in services. If these are added, the U.S. ledger improves somewhat. The U.S. enjoyed an overall service trade surplus of over \$2 billion<sup>2</sup> in 1984, while Japan ran a \$7 billion service deficit.

Normally the bilateral trade balance between two specific countries is of minor consequence. It is nearly impossible and not particularly desirable for the U.S. to run a trade surplus with each of its trading partners. The U.S. merchandise deficit with Japan attracts great attention primarily because the \$37 billion constitutes the largest single portion--about 30 percent--of the global U.S. merchandise deficit.

<sup>1</sup> Katsuro Sakoh, "Food Exports and the U.S.-Japan Trade Deficit," Asian Studies Center Background No. 15, The Heritage Foundation, Washington, D.C.

<sup>2</sup> United States Trade: Performance in 1984 and Outlook, U.S. Department of Commerce, International Trade Administration, p. 140.

## THE MEANING OF TRADE STATISTICS

Merchandise trade figures reflect the value of a country's trade in manufactured and other goods. They say nothing about investment or services. As such, a merchandise trade deficit does not necessarily imply a problem. A growing economy can run such a deficit indefinitely, as the U.S. did for the first century of its history, and as it generally has done since 1970.

A better, though less than perfect, measure of international economic transactions is the current accounts balance. In addition to manufactured goods, this includes trade in such services as banking, accounting, advertising, data processing, transportation services, consulting, and income from foreign investments.<sup>3</sup> Many countries receive enough service and investment income to offset their merchandise gap. Until 1981, in fact, the U.S. ran a current accounts surplus.

In a very basic sense, international economic transactions are always "balanced," since the U.S. pays for its imported goods in dollars, which generally are returned to the U.S. to buy U.S. goods and services or make investments in the U.S. If, temporarily, there is a large dollar flow out of the U.S., supply and demand ensure that the value of the dollar will drop. The result: A slowdown in imports and an increase in exports of American goods.

## CAUSES AND IMPLICATIONS OF THE TRADE DEFICIT

Trade protectionism by Japan or other countries is not the underlying cause of the U.S. trade deficit. Rather, the strength of the U.S. economy has resulted in foreign investors purchasing U.S. assets, increasing the value of the dollar, thereby encouraging Americans to buy more imports. Last year, the U.S. economy grew 6.9 percent, the highest level in the industrialized world.

This economic strength, especially compared with the rest of the world, has attracted much overseas capital and encouraged Americans to invest their money at home. U.S. export of new capital peaked at \$119.2 billion in 1982. In 1983 it fell to \$55 billion and in 1984 to \$20.4 billion. In contrast, foreigners in 1984 invested over \$97 billion in the U.S., for a net capital inflow of \$77 billion.<sup>4</sup> Of the new foreign capital invested in

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<sup>3</sup> It should be noted that current methods of calculating service trade might well underestimate its importance. See Jonathan David Aronson and Peter F. Cowhey, Trade In Services: A Case for Open Markets (Washington, D.C.: American Enterprise Institute, 1984).

<sup>4</sup> Economic Indicators, Council of Economic Advisors for the Joint Economic Committee, September 1985, p. 37.

1984, nearly \$50 billion came from Japan. This increased demand for U.S. dollars caused the currency to regain most of the strength it had lost during the 1970s. Thus, while 1984 U.S. exports rose by 8.7 percent over the 1983 level, the increased purchasing power of the dollar spurred a 26.4 percent rise in imports. Imports increased from nearly all U.S. trading partners, not just Japan.

### Jobs and the Trade Deficit

Some policy makers fear that the enormous amount of imported foreign goods destroys U.S. jobs. While there can be no dispute that workers in particular industries have suffered from imports, there is no evidence of an overall loss of jobs. Quite the contrary. While the U.S. trade deficit has grown, nearly eight million net new jobs have been added to the U.S. economy. And since 1975, over 20 million net jobs have been created in the U.S. By contrast, Western Europe has lost two to three million jobs in the past decade, although the trade balances of these countries have been relatively healthy.

### Japanese Savings and Credit

Most American managers marvel at the ability of their Japanese competitors to acquire new capital and equipment. One reason for this is the differing policies of each country toward savings and credit. The Japanese save approximately 17 percent of their disposable household income. Americans save only 5 to 6 percent. Japanese policies encourage a high savings rate. Special "postal accounts," for instance, allow tax-free interest on amounts up to approximately \$15,000. And in general, the Japanese do not pay capital gains on securities. The U.S. taxes capital gains at a rate of 20 percent.

In Japan, no tax deduction is allowed for mortgage interest payments or for interest payments on other consumer purchases, such as automobiles. The U.S. tax system allows such deductions, thus encouraging consumption and discouraging saving. The result: American consumers have greater financial incentives to purchase Japanese goods than Japanese consumers have to purchase American goods. Japanese policies that encourage saving and do not reward consumption ultimately promote capital accumulation. This excess of capital above what is needed for domestic Japanese needs can be employed in more export-oriented industries.

### U.S. GOVERNMENT AND BUSINESS PRACTICES IMPEDING EXPORTS

U.S. government officials and business leaders rightly have complained that some Japanese trade practices hurt American exporters. Often overlooked, however, are the U.S. government and business practices that discourage or even prohibit U.S. exports and others that make U.S. businesses less competitive.

### U.S. Export Restrictions

A number of U.S. policies discourage exports, particularly to Japan. Among them:

1) The U.S. prohibits the export of oil and natural gas to Japan and other countries. Japan could buy as much as \$10 billion worth of American oil per year. The overall U.S. merchandise deficit would not improve much by this, of course, since the U.S. would have to replace part of the oil sold to Japan with oil bought from foreign suppliers. A number of Congressmen advocate allowing such sales, and the Reagan Administration wants to allow sales of at least small quantities of oil from Alaska's Cook Inlet. More helpful would be removal of U.S. barriers to selling as much as \$11 billion worth of natural gas to the Japanese. This gas would not have to be replaced by imports.<sup>5</sup> The result would be a substantial reduction in the trade deficit with Japan.

2) The U.S. prohibits the export of raw timber harvested on federal lands. Japan is a major importer of timber and might purchase as much as \$1 billion worth of federal timber.<sup>6</sup>

3) U.S. cargo preference laws require half of government-financed agricultural exports to be shipped on U.S. vessels. The U.S. Department of Agriculture estimates that this adds about \$35 per metric ton to the price of U.S. wheat exports, thus discouraging foreign purchases.<sup>7</sup>

4) U.S. agricultural price support policies push the cost of American commodities far above world prices. Predictably, this reduces overseas sales of U.S. farm products, damaging both the U.S. merchandise balance and the earnings of the U.S. farmer.

### U.S. Production Costs and Quality

Many U.S. businesses have been slow to adjust to changing international economic conditions. For two decades after World War II, the U.S. faced little global competition for most manufactured goods. The recovery of Western Europe and Japan changed this. Yet the U.S. simply has not moved to match the cost and quality of Japanese products. Japanese companies, for instance, produce small cars for \$1,500 to \$2,000 less per unit than do American firms. The Japanese car, moreover, is widely regarded as superior in quality. Similarly, in the 1970s, U.S. steel companies have to invest sufficiently in modernization, despite

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<sup>5</sup> Milton Copulos, et al., "Exporting Alaska's Oil and Gas," Heritage Foundation Backgrounder No. 248, February 22, 1983.

<sup>6</sup> Steve Hanke, "U.S.-Japanese Trade: Myths and Realities," The Cato Journal, Winter 1983/85.

<sup>7</sup> The Economist, August 3, 1985, p. 23.

obtaining import restrictions in the late 1960s and the 1970s to allow a "breathing space" for that purpose.<sup>8</sup>

Many U.S. firms now recognize that quality, management, and investment shortcomings handicap their ability to compete. To remedy this, many potentially competitive U.S. industries, such as autos and textiles, have begun investing in new technology, changing management techniques, and seeking other ways to become more efficient. The U.S. government can encourage such efforts by streamlining regulations and reforming taxation policies. Antitrust laws that discourage productive cooperation between U.S. firms, for example, should be changed.<sup>9</sup> And business taxes should be cut further.

#### THE EXTENT OF JAPANESE TRADE RESTRICTIONS

While the U.S. government and businesses can take steps to promote U.S. exports, Japanese trade barriers continue to hinder the entry of U.S. goods. Yet the magnitude of the problem is often exaggerated. The U.S. Department of Commerce has estimated an initial potential sales increase of only \$10 billion for U.S. exports if Japan were to remove nearly all of its trade barriers--which is no more likely than for the U.S. to drop all of its barriers. Moreover, the Department's study also assumes that U.S. companies could acquire the same market shares for various products in Japan as they currently hold worldwide. But resource-poor Japan relies heavily on exports of manufactured goods to pay for basic imports, so the pattern of U.S. trade with Japan would probably not match the Commerce Department's assumptions.

And, of course, even if Japan were to open its markets completely, many other countries would compete vigorously with U.S. goods for market shares. Australia and New Zealand, for example, would mount a serious challenge to U.S. agricultural commodities.

In another study of U.S.-Japanese trade, economists C. Fred Bergsten and William R. Cline of the Institute for International Economics, find that the potential U.S. sales increase accompanying an elimination of Japanese trade barriers would fall within a range of \$5 to \$8 billion.<sup>10</sup> Thus the removal of Japanese trade barriers, while certainly very helpful and long overdue, would cause only a small dent in the trade gap.

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<sup>8</sup> Kent Jones, "Saving the Steel Industry," Heritage Foundation Background No. 354, May 21, 1984.

<sup>9</sup> Edward L. Hudgins, "36 Ways to Narrow the U.S. Trade Deficit," Heritage Foundation Background No. 457, September 24, 1985, pp. 8-11.

<sup>10</sup> See C. Fred Bergsten and William R. Cline, The United States-Japan Economic Problem, preliminary draft, July 10, 1985, Institute for International Economics, Washington, D.C., for an in-depth analysis of the Commerce estimate.

