CHAPTER 1

Introduction

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The issue of trade friction and general tensions concerning economic policy between the United States and Japan is not a new one. For almost 20 years the issue has appeared in popular economic discussions. Sometimes events make the frictions more heated than at other times, but there is usually some manifestation of the issue. This volume presents the proceedings of a conference held in 1986, a year in which the policy frictions between the two allies were particularly heated. However, the issues discussed are of broader interest than the crises reported in the daily press. Indeed, the conference program and discussions attempt to put these crises in perspective and thereby contribute to our understanding of economic policy in a constructive manner.

The chapters presented here address three broad questions that are the source of the three topical groupings in the table of contents. The questions are:

What are the sources of trade friction?
What are the appropriate macroeconomic policy responses?
What are the appropriate trade policy responses?

That these questions are posed does not presume that there are definitive answers. In fact, the very issue of whether friction exists or whether there is any substantive basis for the apparent frictions expressed in both countries needs to be explored. In addition, it is possible that no response is the appropriate policy action. Indeed, some of the views expressed in this volume favor little or no policy response.

The essays in this volume are a combination of research papers, policy speeches, and discussions presented at a conference sponsored by the Center for Japan–U.S. Business and Economics Studies at the Graduate School of Business Administration at New York University. The conference was held on April 10 and 11, 1986, in New York and was organized by the editors. Although the essays have very different formats, ranging from academic studies to luncheon speeches, they have been prepared for publication in a form that we hope will be readable to everyone. This introduction will provide a guide for the interested reader to the issues, ideas, and conclusions of the essays.[1]

The sources of trade friction

The first chapter in Part I is perhaps the most timely. It is by Yoshio Okawara, the former Japanese Ambassador to the United States and a member of the Advisory Group on Economic Structural Adjustment for International Harmony – the Maekawa Committee. The committee was a high-level government group formed to make recommendations on how to alleviate Japanese–U.S. trade frictions. The commission's report was made public shortly before the conference, and Ambassador Okawara summarizes and evaluates the policy initiatives recommended by the Maekawa Committee.

Okawara acknowledges that eliminating the trade surplus is desirable but that it is important to do so without adversely affecting Japan's economy. To accomplish this requires nothing less than a combination of industrial restructuring of the Japanese economy and strong stimulus to domestic demand in Japan. Although a realignment of exchange rates and international cooperation on trade issues would be helpful, Okawara emphasized the need for long-term solutions. The Japanese economy must be restructured away from its export orientation and toward production geared to meeting domestic demand. These changes take time, so that substantial progress in reducing the trade imbalance and improving trade relations may be some time off. Nevertheless, Okawara is confident of the willingness of the Nakasone government to bring about such changes even in the face of political opposition in Japan.

A more formal analysis of the sources of trade friction is presented in the chapter by Paul Krugman of the Massachusetts Institute of Technology. He bluntly states that the economic tension between Japan and the United States owes little to Japanese trade and business practices. Instead he attributes the friction to the speed with which the large surplus occurred in response to changing terms of trade in the world economy. This is a rather optimistic interpretation because it

[1] One of the essays was not actually presented at the conference. The chapter by Paul Samuelson is based on a public lecture sponsored by the Japan–U.S. Center at the NYU Graduate Business School in December 1985. In addition, one of the papers presented at the conference was not available for publication. It is "Japanese Worker's Skills and Shopfloor Techniques in Comparison with the U.S." by Kazuo Koike of Kyoto University. It was discussed at the conference by John Rizzo and Paul Wachtel, both of NYU.

implies that changes in exchange rates will lead to a gradual correction of the imbalance. Krugman is confident that the problem will be solved in the long run by the revaluation of the yen to about its current level. Thus, no new initiatives are called for. Patience and exchange rate stability around existing levels will bring about a correction to the imbalance of trade flows.

Trade frictions heated in the 1980s because an unusual set of circumstances combined to result in the very rapid emergence of an enormous bilateral trade imbalance. These were the increase in energy prices, which led to a deterioration of Japan's terms of trade, and an overvalued dollar in world financial markets. Since 1985, both the dollar and the price of oil have fallen precipitously, which will cause the imbalance to shrink and frictions to disappear. Thus, Krugman does not put much credence in the idea that there are structural aspects of the two economies that need to be changed. The contrast between Krugman's view and the Maekawa recommendations endorsed by Ambassador Okawara is startling.

A mediating point of view is expressed by Masaya Miyoshi of the Keidanren (Japan's Federation of Economic Organizations). Like Krugman, Miyoshi regards the allegations that Japan engages in unfair trade practices as groundless. He attributes the recent trade frictions to the unanticipated size of the imbalance of trade and resulting panic in the United States over America's apparent decline in international competitiveness. However, Miyoshi is not willing to rely on exchange rate realignment and coordinated macroeconomic policies to change the situation. He instead advocates a role for structural change in both economies as a necessary part of the process.

The structural changes that Miyoshi emphasized are different from those suggested by Okawara. He called for increased export efforts by American industry. In his view the issue is not barriers to the Japanese markets but the need for American industry to develop marketing efforts abroad. Miyoshi places the burden on the United States to change the structure of business activity while Okawara places a greater burden on Japan to change the structure of domestic demand. Miyoshi and Okawara are in agreement that the devaluation of the dollar is not sufficient to reduce the trade frictions that have emerged.

The final chapter in this part of the volume is a historical overview of one of the possible sources of trade friction. It is very common in the United States to blame Japanese industrial policy for creating an economic structure that inhibits fair trade or creates barriers to Japanese markets as it promotes economic growth. Kotaro Suzumura of Hitotsubashi University and Masahiro Okuno-Fujiwara of the University of

Tokyo and the University of Pennsylvania provide a thorough review and critique of Japanese industrial policy in the post–World War II period. Their analysis calls into question the popular notion that industrial policies in Japan have played a critical role in promoting its extraordinary economic development. They conclude that these policies have been at best neutral and possibly even counterproductive.

Suzumura and Okuno do not only contend that Japanese industrial policy is not the cause of trade friction. They go on to imply that industrial policy in Japan has been generally ill-conceived. The chapter presents two basic reasons for this conclusion. First, Japan's industrial policy has, for the most part, been advisory in nature. Thus, it is only followed when private incentives to do so are present. Second, the welfare criteria adopted for determining which industries to assist lack any compelling theoretical motivation. The criteria used have been basically ad hoc. Nevertheless, the authors do not acknowledge a completely laissez-faire approach. They suggest that there is a role for industrial policy in such areas as information dissemination and the promotion of cooperative research and development efforts.

Trade friction and macroeconomic policy

The second part of this volume deals with issues of macroeconomic policy in Japan and the United States. The part begins with discussions of macroeconomic policy and the relationships between the two countries by two prominent American economists. The first is by Nobel laureate Paul Samuelson, Institute Professor at MIT and the first Long-Term Credit Bank of Japan Visiting Professor of Economics at NYU's Japan–U.S. Center. The second is by Herbert Stein, formerly chairman of the President's Council of Economic Advisors and currently at the American Enterprise Institute. Stein is confident that the frictions of the early 1980s will give way shortly to an era of trade harmony. Samuelson warns that although the frictions associated with the large trade deficit are likely to diminish, they will not disappear quickly, and a protectionist reaction is a real possibility.

Samuelson attributes the current situation to the natural post-war development of the Japanese economy. He argues that protectionist trade policies would not be a beneficial way of responding to the growth in the international economy. He blames the macroeconomic policy of the Reagan administration for the overvaluation of the dollar in the early 1980s and views the decline since February 1985 as fortuitous. However, Samuelson is not at all sure that the coordination of fiscal and monetary policies among major countries will maintain stability.

A more optimistic interpretation of events is presented by Herbert Stein. He notes that trade frictions have emerged before and have disappeared as well, and he forecasts that by 1988 the appropriate title for a conference will be trade harmony. Like Samuelson, he blames the U.S. macroeconomic policies of the 1980s for the trade deficit. Those policies led inevitably to large capital inflows, and a trade deficit is a necessary corollary to capital inflows. Although this situation is detrimental to some industries, avoiding it would have hurt other industries. In addition, the overall performance of the U.S. economy has been rather good. Finally, Stein views a number of developments already underway as sufficient to make the frictions disappear. These include an emerging willingness by Japan to save less and export less, the revival of the European economies, and a willingness by the United States to reduce the government deficit.

The next chapter is a review of trade relations and macroeconomic developments in Japan and the United States by Roy Smith, a general partner of Goldman-Sachs who has been active in their business relations with Japan for many years. Smith shows how the current situation is the logical consequence of macroeconomic policies over a long period. He views the trade deficit as a persistent and troublesome problem. In his view, it could be managed better, and steps could be taken to ameliorate the problem. Smith does not think that the Japanese propensity to save will change nor will the Japanese attempt to reduce their growth rate as a means of reducing the American trade deficit. He does suggest several steps that will enable the two economies to better cope with the situation. These include further steps to deregulate Japanese financial markets, efforts by Japan to cycle financial surpluses to other countries besides the United States, and continued growth of Japanese direct investments in the United States.

The final chapter in this part is on the effects of exchange rate intervention and the yen appreciation that began in 1985. It is by Kazuo Ueda of the Ministry of Finance and Osaka University. Ueda is particularly interested in the effects on exchange rates and the trade balance of the famous G5 (the group of five major central banks) meeting in September 1985. At that time the United States and Japan agreed to appreciate the yen through monetary intervention. Ueda emphasizes that political realities are likely to constrain any strong fiscal actions by either country. His concern is whether monetary intervention will be successful. His conclusion is that intervention will be helpful only if macroeconomic policy can also provide stable underlying economic conditions.

If U.S. real economic growth averages only 2% per year over the next decade, then Ueda estimates that the American budget deficit will soar and the long-run equilibrium yen exchange rate will plummet. On the other hand, 4% real growth in the United States would make it possible to maintain the deficit-to-GNP ratio at the current level. Ueda supports the use of foreign exchange interventions such as that implemented after the G5 meeting; he recognizes that political realities restrain the more structural changes that would be brought about with fiscal policy.

The use of trade policy

The chapters in this part are on two recent applications of trade policy that resulted from concern about U.S.–Japanese trade relations. The first is a detailed analysis of the costs and benefits of an important American trade barrier. David Tarr of the Federal Trade Commission and the World Bank analyzes the 1985 steel import quota program. The second is an analysis of trade practices and government policies in the semiconductor industry. Thomas Pugel of New York University analyzes the efforts of the American industry to seek protection and the attempts of both governments to evolve a cooperative policy. Although the two industries under study here are very different, neither author finds much support for market intervention, which interferes with free trade.

Tarr describes the history of trade policy in the United States for the steel industry. Since 1969, the industry has enjoyed a significant amount of protection from imports. Most recently the United States and its trading partners have agreed to restrict steel imports to less than 20% of domestic consumption. Tarr shows that consumers are paying significantly higher prices as a result of the quotas. These higher prices represent transfers from consumers to the steel producers and workers and also to overseas producers. His estimates indicate that each job in the steel industry saved by the quota costs consumers $114,000 and costs the American economy $81,000.

In contrast to the steel industry, the semiconductor industry is one where both technology and industrial structure are changing very rapidly. Consumption and trade in the industry grew rapidly for over a decade until 1984. At that time the worldwide industry entered a recession that spawned severe trade friction between the United States and Japan. Pugel presents a detailed summary of the various actions taken by producers and by governments since late 1984. At that time the trade frictions turned into formal trade actions against the Japanese firms and government.

Pugel describes trade actions of three different types. First, in 1985 several American firms brought dumping suits against Japanese exporters. Pugel describes and evaluates the procedures for examining these allegations by the International Trade Commission and the Department of Commerce. The second form of trade action was the efforts of American firms to protect their intangible assets, basically chip design and process technology. Finally, the U.S. industry and government have made formal allegations of unfair trade practices to the Japanese government. Pugel finds little basis for the allegations of unfair trade practices, although he is sympathetic with efforts to protect proprietary designs and processes from infringement.

Conclusion

A reading of the entire conference volume provides an interesting perspective on the agreements and disagreements concerning issues of trade friction and economic policy. Some authors fear that the trade deficit could have a devastating impact on the American economy, while others view it as relatively benign. Some are confident that the appreciation of the yen will have a strong impact on the deficit, while others doubt this. However, there seems to be widespread agreement that restrictive trade policies are not a worthwhile means of reducing the trade deficit.

The conference participants also agreed that the dollar had been overvalued. A few even ventured to suggest what the equilibrium exchange rate should be. Both Paul Krugman and Richard Marston offered the figure of 140 yen to the dollar. Japanese participants suggested that such a high value for the yen would be too disruptive to the Japanese economy to be acceptable.

A final point of discussion at the conference was simply whether allegations of trade friction are justified. Although many feel that Japanese markets are to some extent closed to foreign competition, these barriers have been diminishing. Trade friction should emerge only if such barriers are increasing, which is not the case. Similar thoughts were expressed concerning allegations of unfair trade practices by Japanese exporters. Although they may exist, there is no indication that they are becoming more of a problem. What then is the source of the apparent friction?

The consensus view is that trade friction arises because of the rapid growth of Japanese exports of highly visible manufactured consumer goods. Trade friction seems to be the consequence of Japanese product innovation and productivity improvements that result in the trade imbalance. Although governments should be careful to ensure that instances of unfair trade practices do not emerge, it does not follow that direct policy initiatives to interfere with free trade are advisable. The macroeconomic equilibrating process will lead to the gradual disappearance of the trade imbalance and with it the perceptions concerning trade friction. Thus, the consensus view is basically an optimistic one.

Many of the chapters are followed by comments that were prepared for the conference. These discussions provide some valuable additional insights the reader should not overlook. Finally, this volume is only one of several such volumes sponsored by the Center for Japan–U.S. Business and Economic Studies at NYU on related topics. Readers of this volume are more than likely to find the others of interest as well.

PART I

Sources of trade friction

CHAPTER 2

Restructuring the Japanese economy from a global perspective

YOSHIO OKAWARA

Trade friction between Japan and the United States is an obvious fact. What is far less obvious is how each nation will address this problem. In this chapter, I would like to discuss how Japan proposes to alleviate the trade friction that has resulted from an enormous Japanese surplus on its current account and a correspondingly enormous U.S. current account deficit.

In addressing this problem, one is at first confronted by its sheer enormity. How are we to deal with the huge external imbalances facing the global economy today? How can we literally restructure the Japanese economy in a manner that will alleviate international friction while preserving domestic tranquility? Japan's approach to this admittedly large and complex issue has been three-fold. First, efforts, must be made to improve market access and increase domestic demand. Second, exchange rate realignment should be implemented. And finally, efforts must be made to restructure Japanese industry along more productive lines by gradually shrinking economically depressed industries.

In the course of the past year, important and encouraging developments have already occurred on the world economic scene. Cooperative efforts to realign exchange rates have been more or less successfully implemented, interest rates have declined, and new initiatives to address the debt situation have emerged. A series of measures have been adopted by Japan to improve market access and expand domestic demand, and European efforts to redress structural rigidities are at least being discussed. Finally, recent oil price declines are also considered to have beneficial effects in general, although the full impact on oil-producing and debtor countries is yet to be assessed.

It is also true, however, that a number of serious problems remain that, if not properly addressed, could threaten the sustainability of world economic growth. The predominant cause of our current difficulties is the international trade imbalance, particularly with respect to