



Background

The Heritage Foundation • 214 Massachusetts Avenue, N.E. • Washington, D.C. 20002 • (202) 546-4400 • Telex: 440235



13

May 16, 1984

HOW TO NARROW THE TRADE GAP WITH JAPAN PART II

INTRODUCTION

The red ink in U.S. trade with Japan has been soaring. The fiscal year ending March 31 saw the deficit exceed \$21 billion. And unless immediate corrective measures are taken, the deficit will be even larger next year and the years after that.

This huge trade imbalance is making Japan a scapegoat for the loss of American jobs. Labor unions are pushing Congress to enact laws requiring that autos sold in the U.S. contain almost solely U.S.-made parts and to legislate higher tariffs and quotas against Japanese products. A growing number of liberals has embraced protectionism, a dramatic and potentially fateful turn-around from their free trade advocacy of the past.

The attitude toward Japan in many ways resembles the attitude espoused toward foreign countries in general just before the collapse of world trade in the late 1920s--which was a prelude to the Great Depression. Clearly free trade will suffer seriously in the 1980s if this attitude toward Japan spreads. Protectionism, moreover, cannot solve the problems that have created the huge U.S. trade deficit. Instead, other measures must be adopted. There are two categories of such actions: (1) measures to increase U.S. exports to Japan (which can be taken by both the U.S. and Japan); and (2) other remedial efforts, such as internationalizing the Japanese yen and increasing Japanese foreign assistance.

THE DEFICIT IN PERSPECTIVE

The red ink with Japan merely symptomizes a large and growing U.S. balance of trade deficit. Last year the U.S. purchased \$70

*Part I of this study appeared April 11, 1984 as Asian Studies Center Background No. 10.

billion more than it sold abroad. This is expected to increase to \$100 billion in 1984 and to over \$190 billion by 1990. The strong dollar and a quick U.S. recovery last year exacerbated the deficit. This was particularly true for Japanese trade, making the deficit with Japan worse than it might have been. Nonetheless the overall trade deficit is still a serious long-term problem.

Throughout the 1950s and early 1960s, the U.S. consistently recorded a surplus in its trade with Japan. This changed in the mid-1960s for a number of reasons: the Vietnam War (which stimulated Japan's economy) made U.S. industry less competitive; increases in labor productivity, innovation, and quality control in Japanese manufacturing coincided with slow growth and even declines in these areas by U.S. producers; the public sector grew and taxes increased markedly in the U.S., as did government bureaucracy and red tape (while Japan was spared this), making U.S. goods less competitive in both domestic and international markets. During part of the period Japan also had the advantage of higher tariffs.

The current \$21 billion deficit, which is up markedly, is due in large part to the new strength of the U.S. dollar caused in part by the quick U.S. recovery--over 6 percent GNP growth in 1983 compared to Japan's 4 percent. A strong U.S. dollar puts additional buying power in the hands of American consumers, who have become increasingly attracted by Japanese products. These U.S. imports from Japan are mainly modern manufactured and consumer goods, which increase in price along with the greater demand caused by the stronger dollar. Meanwhile, Japan imports food and raw materials from the U.S., which do not increase much in price during an economic upturn. Thus the problem becomes particularly acute.

The trade deficit is blamed for U.S. unemployment and the decline of certain U.S. industries. This is in part erroneous thinking since goods imported from poorer, labor-intensive countries cause greater losses of jobs relative to the value of the goods.

The U.S. has vast global responsibilities and will probably continue to provide large amounts of economic assistance to developing nations (this year alone amounting to over \$10 billion if donations to international institutions are included). Because access to the U.S. market is given to developing nations as a form of development assistance, the U.S. will in the foreseeable future sustain a current account or balance of payments deficit. Moreover, because the U.S. dollar is the most used and for the most part the only international currency, the U.S. trade deficit serves to supply a medium of exchange for a network of expanding global trade.

Sometimes the U.S. trade deficit is blamed on Japan's alleged lower wages, higher tariffs, national industrial policy, and

Tokyo's determination to keep out competitive imports, which make it difficult to impossible for U.S. export products to compete in the Japanese marketplace. These charges are contradicted by the facts: (1) Japanese wages are around 50 percent above those in the U.S. (2) Japan has the lowest average tariff rate on manufactured goods of any advanced industrial nation--including the U.S. (3) Japan's so-called industrial policy amounts to little more than good management, the absence of government red tape, lower corporate taxes, and few labor difficulties. Japan's Ministry of International Trade and Industry (the "famed" MITI) in the past has given very bad advice. Example: It told Japanese businessmen not to get into the transistor or auto business. Few Japanese businessmen regard MITI as a good planner in terms of exports.

The U.S.-Japan trade imbalance, moreover, is to a considerable degree offset by Japan's deficit with the U.S. in so-called invisibles--payments on patents purchased from the U.S., profits of U.S. companies in Japan, U.S. companies selling products from other nations in Japan (including large quantities of petroleum). It is also offset by a deficit with the U.S. in the capital account--caused by large amounts of Japanese investment in the U.S. Much of this investment paves the way for the transfer of Japanese managerial expertise and therefore adds to the competitiveness of U.S. business. It also holds down interest rates in the U.S.

Another important point that must be recognized is that Japanese imports per se have spurred the competitiveness of U.S. industry. Note the improvements made in American autos in both quality and gasoline mileage since Japanese cars entered the U.S. market. Japanese products also have given the consumer greater choice and the advantage of generally longer lasting and frequently safer products. And many Japanese products (again most notably the auto) have helped the U.S. ease its energy problem.

NARROWING THE TRADE DEFICIT BY EXPORTING TO JAPAN

The U.S. can take a number of steps to reduce the trade deficit. Among them:

1. Sale of petroleum and natural gas from Alaska. Nearly one-third of Japan's total imports by value are petroleum and natural gas. The sale of Alaskan oil and gas would amount to \$2 to \$3 billion immediately and possibly in excess of \$15 billion annually, or around three-fourths of the present deficit, over the long run. Japanese companies and political leaders have expressed a desire to purchase Alaskan oil and gas and are willing to sign contracts immediately.

These sales currently are blocked by U.S. legislation preventing the export of Alaskan oil and gas--for security among other reasons. Inasmuch as Japan is considered America's number one

ally in Asia and perhaps the world, the security aspect of these laws should not apply to Japan. Furthermore, since there is a glut of oil on the U.S. West Coast, wells in Alaska are not operating at full efficiency and additional exploration is being held up. Sales of petroleum and natural gas from Alaska to Japan would also serve to stimulate production in Alaska and California as well.

The problems with this solution are several. U.S. oil companies have invested large sums in pipelines and have concluded shipping agreements with various U.S. transporters to send Alaskan oil to other parts of the U.S. than just the West Coast. Also the sale of Alaskan oil and gas would affect the business of U.S. companies that are selling Middle East oil to Japan.

2. Cigarettes and other tobacco products. Currently the U.S. has less than 2 percent of the Japanese cigarette market because of various barriers erected by Tokyo. In contrast, the U.S. has half of the Hong Kong market--where there are few artificial trade barriers. Since the Japanese spend around \$10 billion annually on cigarettes and tobacco, the U.S. trade deficit with Japan could be narrowed by about \$5 billion simply if Tokyo allowed the free and unobstructed importation of U.S. cigarettes and tobacco products and if the U.S. captured half of the Japanese market.

The restrictions in Japan are supported by unions and wholesale organizations and by a very small group of farmers--none of whom has a broad base of political support. Moreover, the Japanese government need only abide by agreements already made with the U.S. and expand upon them in future years to open the Japanese tobacco market.

3. Communications equipment, computers, semiconductors. U.S. manufacturers of these products have a competitive edge in many fields, yet face many nontariff barriers when trying to export to Japan. The trade deficit thus could be narrowed significantly if Japan repealed its protectionist policies.

This is especially true of communications satellites. Japan does not produce large satellites. Import restrictions exist only because Japan is developing its own space industry.

Currently the U.S. has an estimated 1.3 percent of the market in Japan in communications equipment. U.S. producers are being kept out because of agreements among Japanese manufacturers and special understandings between Japanese companies and government officials. Japanese companies want to develop this industry in the future and therefore seek protection against U.S. products.

Nippon Telephone and Telegraph has promised, under pressure of the Japanese government, to open bidding to foreign companies. American companies can compete easily on the basis of cost and quality. Yet U.S. manufacturers have not been winning large

contracts because of various bidding rules and other artificial barriers. If this situation were to change, several billion dollars could be cut from the U.S. trade deficit.

In the computer and semiconductor field, U.S. sales are much lower than they should be considering the competitiveness of U.S.-made products. U.S. penetration is kept low, however, by agreements between Japanese manufacturers and the government. The U.S. market is not protected from foreign products in the same way or to the same degree as is the Japanese.

This situation is especially disadvantageous for U.S. large computers. Americans produce large computers cheaper and of better quality than Japan, and comparative advantage is with U.S. producers. Yet the sale in Japan of large U.S.-made computers is hampered by very restrictive trade barriers.

There is also a serious problem regarding computer software. In fact, here protectionism may be getting worse. Legislation is pending in Japan to reduce the length of copyrights from about 50 years--recognized by international convention--to 15 years on U.S.-made computer programs. This discriminates against U.S. computer companies and individual Americans. Laws also may be enacted in Japan that would keep U.S. companies out of the business of value added networks, lucrative services that include packet-switching data transmission, which allows dissimilar computers to "talk" to each other. These services relate to electronic mail, credit card checks, airline flights, and hotel reservations. Legal restrictions now under consideration would bar such companies with more than 40 percent foreign ownership from the Japanese market. This would exclude American companies from Japan since the best and most competitive are mostly U.S.-owned.

4. U.S. weapons sales to Japan. Japan's defense budget currently exceeds \$11 billion. A large portion of this is used to procure sophisticated weapons. While Japan has a number of licensing agreements to produce U.S.-designed weapons in Japan, the large trade deficit should prompt Tokyo to purchase weapons directly from the U.S.

5. Sales of timber and wood to Japan. U.S. exports of these goods are lower than they could be because of restrictions on logging on federal lands and restrictions that prevent the export of raw timber as opposed to finished wood products, which are exported without restriction. Most of the soft woods, which Japan imports from the U.S., are on federal lands where harvesting is far below the level required to preserve the forests or abide by the practice of "sustained yield."

If the embargo on the export of logs from public lands were modified or reduced and the laws changed to allow the export of unprocessed wood products, annual U.S. sales to Japan could increase by \$1 billion or more.

6. Sales of fish to Japan. Japan is a major customer of U.S. fish. Currently most Japanese purchases are made immediately after the catch. As a result, processing and marketing are done in Japan, which means the needs here are to be able to increase sales of processed products (just the opposite of those in the lumber industry). This could be changed so that Japanese firms contract with new, smaller U.S. fishing companies for delivery of the processed and packaged product. Japanese-owned companies in Alaska and the West Coast could also do more processing. The U.S. government, however, would have to help American fisheries, and unions would have to cooperate by allowing more incentives or more efficient labor utilization. This could reduce the U.S.-Japan trade deficit by several hundred million dollars annually. If such actions were to spread and reduce U.S. imports from other nations, the effect could be in the billions of dollars.

7. Coal sales. Japan is a major importer of coal, but the U.S. has only a small portion of the Japanese market. The reason: high costs, poor transportation facilities in the Western U.S., poor harbors, costly unloading and reloading in the West, and the fact that Japanese companies mix U.S. coal with inferior domestic coal for resale competing in the same markets with U.S. exporters. While it would take some years for the U.S. to become competitive in coal sales to Japan, the potential over the long term is considerable.

8. Beef and citrus. These two items have become very symbolic in terms of resolving the trade deficit with Japan. At most, however, they could improve the trade balance by only a few hundred million dollars. There are two disadvantages in pressing Japan to purchase additional quantities of these items: (1) Japanese producers are supporters of the pro-U.S. Liberal Democratic Party and favor closer relations with the U.S.; (2) Japan is already the largest purchaser of U.S. farm products. As a consequence, these items do not deserve the priority they now have in terms of adjusting the balance of trade.

OTHER SOLUTIONS TO THE TRADE DEFICIT

Other measures can also be taken to help resolve the balance of trade deficit with Japan. Most of these generally long-range answers involve trade or financial agreements between the two countries or constitute indirect solutions to the trade deficit. Among them:

1. Internationalize the Japanese yen. While the yen is a widely transacted currency, it does not begin to approach the use of the dollar. The Japanese government in the past adopted policies to prevent widespread use of the yen to avoid the external pressures that come from having an international currency.

If the yen were internationalized to a greater extent, it would help offset the need for using the dollar in international

transactions. This would lead to a depreciation of the dollar and a strengthening of the yen--thereby making U.S. exports cheaper for Japanese purchasers. This could be accomplished if the Japanese government were to loosen restrictions on the use of the yen in trade and other transactions and encourage its holding and use by other countries.

2. Open Japan's capital market. Lack of foreign investment opportunities in Japan means that Japan invests heavily in the U.S., while limiting U.S. investment in Japan. This is, in fact, desirable in the short run since it keeps interest rates from rising in the U.S. and since Japanese investment in the U.S. generally brings with it Japanese management and production skills, thus contributing to the strength of the U.S. economy by increasing productivity.

Over the long run, however, the absence of a better investment climate in Japan obstructs the internationalization of the yen and reduces the marketing potential of U.S. firms as well as U.S. business profits in Japan. It also weakens the yen in terms of its trading value, thus making Japanese goods cheaper in the U.S. and U.S. goods less competitive in Japan. As a long-range policy, Japan should be encouraged to open its capital market.

3. Increase Japan's defense responsibilities. At present, Japan's defense role, even in Northeast Asia, is tiny relative to Japan's economic strength and its military potential. Japan has promised to play a larger part and take additional responsibilities. Increasing Japan's defense budget would reduce the military burden for the United States in Japan and thereby affect the balance of payments, since U.S. defense spending in Japan is considerable. The U.S. would also benefit directly from reduced military spending elsewhere in Northeast Asia if Japan were to assume a larger share in defense.

Another way for Japan to help with defense would be to grant additional support to U.S. military personnel stationed in Japan. Tokyo could place this in a nondefense budget allocation.

Japan increased its defense budget by 6.9 percent last year. It needs to raise it by perhaps 10 percent annually for several years to take on its appropriate responsibility for the defense of Northeast Asia.

4. Increase economic assistance. While Japan claims to be generous in its foreign economic aid--and is, in terms of bilateral economic assistance as a percentage of GNP--much of its aid is tied to buying Japanese goods and Japan gives almost no security assistance. Therefore, Japan should further increase its economic aid to other nations and thereby relieve the U.S. of some of this responsibility. It would be especially helpful to the trade deficit if Japan were to grant more security assistance to nations receiving substantial American aid. Tokyo should be encouraged to "untie" its aid so that the recipient nations could purchase

American goods, if they chose, thereby helping the U.S. deficit problem.

Japan is already providing sizeable economic aid. By most accounts it is as generous or more generous than many Western countries. Much of its aid is to strategically important nations. South Korea, for example, is to receive \$6 billion in Japanese credits--a large portion of them at concessionary rates. Still more Japanese aid, however, could be directed to nations that are important to the U.S. in strategic terms.

5. Improve the Office of Trade Ombudsman. The Japanese government has an organization where complaints regarding unfair trade practices can be registered. This Office of Trade Ombudsman, however, has operated too slowly, and it often delays decisions until they become irrelevant. Many U.S. businessmen who want to market products in Japan find that their requests to the Ombudsman are delayed until a Japanese competitor gets into and captures the market.

Many administrative restrictions, safety regulations, and other confusing governmental procedures obstruct American businessmen who want to export to Japan. This poses fewer problems for Japanese businessmen exporting to the U.S. The Ombudsman Office needs to take more positive action and act more promptly on complaints. It should have the authority to go to court quickly to ensure its efficiency and results for U.S. companies seeking to enter the Japanese market.

6. Revalue the yen. Many argue that the Japanese yen is undervalued and that this makes many U.S. products uncompetitive. There is, however, little evidence supporting this argument.

CONCLUSIONS

The U.S. trade deficit with Japan is a serious economic and political problem. It will become more so in the coming months of the U.S. election year. As November approaches, Japan busting will likely become more popular, especially for union supported candidates.

The trade deficit problem must be seen in its proper context: It is an outcome of declining productivity in the U.S. The revival of American business is the key to resolving the problem. The deficit is currently exacerbated by a strong dollar caused by a stronger recovery in the U.S. than in Japan. This will change as the Japanese recovery catches up.

The solutions for dealing with the trade deficit with Japan could be a model for coping with growing deficits with many other nations--most of which are free market, Asian nations. The problems with a number of these other nations will become more serious in the future if steps are not taken to facilitate competitive U.S. exports.

The basis for solving the trade deficit already has been laid. Reaganomics is making the U.S. economy more productive and competitive. More needs to be done. U.S. taxes must be lowered to a level comparable to Japan, South Korea, Taiwan, Hong Kong, and Singapore. This calls for a decrease in the U.S. public sector and concomitant elimination of red tape and overregulation. If these steps are not taken, then other solutions will not work in the long run.

The alternative to this for many is a protectionism that closes the U.S. market to imports. Protectionism already has many advocates. Labor unions no longer support free trade, nor do many industries--especially steel and autos. Agriculture supports free trade, though it often complains about European Economic Community export subsidies. Consumer organizations support free trade, though they also make many exceptions. The Reagan Administration and most economists support free trade, but even they have become critical of "one way" free trade practices.

Protectionism in the U.S. would be a disaster for world trade, Third World economic development, America's global leadership role, and possibly even world peace.

It is necessary to keep in mind that Japan supports free trade, and therefore, its trade surplus with the U.S. creates serious problems for Tokyo. It strengthens the dollar, which makes Japanese resource imports (such as petroleum) more expensive since they are valued in dollars. It provokes political problems with the United States, which Japan wants to avoid. It weakens the defense alliance.

Japanese leaders want to help resolve the trade deficit problem. In fact, Tokyo has undertaken various measures to reduce the trade imbalance. Some promises, however, have not been fulfilled due to bureaucratic obstructionism in Japan and conflicts between the top leadership and local interests. The promise to open the Japanese market to U.S. cigarettes is a case in point. Japan's leadership agreed to open the market, but its actions were blocked by special interests. As a consequence, American negotiators felt that they had been deceived. The problem is a complex one that needs constant attention and the chance to progress over an extended period of time. Unfortunately its seriousness has political implications requiring immediate attention.

Both Japan and the United States will be hurt by protectionism. So will the rest of the world. Consequently, there is no alternative to working out the problems through sensible action--more U.S. access to Japanese markets, plus other remedial efforts--but not tariffs or quotas or domestic content legislation.

John F. Copper
 Director
 Asian Studies Center