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The Thomas A. Roe Institute for Economic Policy Studies

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U.S.-JAPAN TRADE WAR: THE OPENING BATTLE

INTRODUCTION

For the first time since World War II, the U.S. has retaliated against Japan for alleged unfair trade practices. Specifically, the Reagan Administration charges that Japan has not complied with a bilateral August 1986 agreement, which would prevent Japanese businesses from selling certain semiconductor computer chips in third countries for less than their cost of production, a practice known as "dumping." In addition to the dumping charge, the Reagan Administration maintains that the Japanese government has failed to permit U.S. firms to win more than a 10 percent share of the Japanese chip market. To retaliate against these alleged practices, the Administration has placed 100-percent tariffs on some $300 million worth of Japanese imports, effectively keeping many of these goods out of the U.S. market.

Agonizingly Slow Japanese. This trade dispute illustrates the dilemma faced by U.S. policy makers dealing with Japanese trade policy. The Japanese have been agonizingly slow to open their markets to U.S. goods and services. This understandably frustrates Americans and prompts demands that Washington do "something" to force the Japanese to move more quickly. The typical view is that only by getting tough will the U.S. open the Japanese market to more American products. Moreover, say many Reagan officials, it is necessary to take controversial protectionist action now, risking a trade war, to avoid sweeping protectionist legislation from Congress.

Clearly shooting across Japan's bow makes some sense if it shocks Tokyo into reducing restrictions on U.S. imports. But experience teaches that such shots often go astray. Sharp but limited sanctions to make the other side "see reason" in the past have led at times to all-out trade wars. And even if the strategy has initial success, Congress may simply smell blood and push even harder for further protectionist legislation.

In this "microchip war," the economic case is very clear. It makes bad economics and it victimizes Americans and other customers of the Japanese microchips. The original microchip agreement was no more than a cartel arrangement between the U.S. and Japan to keep up prices and to divide up the world market. American retaliation last week thus was no more than a sanction to enforce the cartel.

Befitting a Third World Country. Opening up the Japanese market to U.S. goods, on the other hand, would benefit America and Japan. Tokyo, moreover, at last must recognize that the post-war era is over and that Japan must begin behaving as the advanced industrial country that it is. The way that Japan protects its domestic market and finds ways to keep out foreign goods befits a Third World country, not wealthy, high-tech Japan. The Reagan Administration is thus correct to seek some means to force Japan to accept the responsibilities of maturity.

But the Administration is probably wrong when it commits the U.S. to defensive action on such a questionable issue as enforcing a cartel. The microchip agreement was a mistake. The Administration should negotiate with Japan an end to the agreement and to the punitive U.S. tariffs. In exchange, given the action already taken by Washington, the U.S. should seek reductions of real Japanese barriers to such U.S. products as telecommunications equipment, beef and citrus products, services, and construction. Above all, U.S. negotiators should tread warily. A trade war is a mutual assured destruction approach to international economics. All sides lose. Conversely, free trade benefits all parties involved. The Administration must not risk losing the benefits of free trade, especially over the computer chip issue.

THE COMPUTER CHIP AGREEMENT

In 1986 a number of U.S. semiconductor producers complained that their Japanese counterparts were "dumping" certain types of semiconductor memory chips in the American market and in third markets.[1] By dumping, the U.S. firms meant that the Japanese firms were selling below their costs of production. It also was alleged that Japan so restricts its domestic market to U.S. semiconductors, that U.S. firms could obtain only a 10 percent share of that market.

To head off potential action by the U.S. government against these practices, Tokyo last August signed a semiconductor chip agreement with the U.S. The document contained two principal concessions by Tokyo. The Japanese government:

1) **Agreed to monitor exports** of their firms and to ensure that these firms were not selling semiconductors either in the U.S. or in third countries for less than the costs of production. The production cost was to be determined by the U.S. government.

2) **Promised to promote the sales** of U.S. memory chips in Japan and to ensure that the U.S. market share increase significantly over the 10 percent level. If necessary, the

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1. For a good overview of this trade dispute, see Michael Becker, "Semiconductor Protectionism: Goodbye Mr. Chips," Citizens for a Sound Economy <u>Issue Alert</u>, No. 9, August 27, 1986.

Japanese government would force its companies to curtail production, to create a shortage to be filled by U.S. products.

The result of this, in effect, was an international cartel for semiconductor chips.[2] In a cartel the major suppliers of an item attempt to divide the market and regulate supply and price to keep prices above the level which supply and demand would dictate. It is anathema to the principles of free trade. The Organization of Petroleum Exporting Countries is an example of such a cartel.

When the parties to a cartel are private businesses, the attempt usually fails, since other suppliers can enter the market and undercut prices.[3] But when governments create and enforce a cartel, the power of each government can be used against firms seeking to avoid the agreement. In such cases, cartels can survive. In the case of semiconductors, the U.S. government determines the price and the Japanese government is expected to enforce the price floor against its own producers, to allow American firms to sell their products for equally high prices. The victims of this cartel, as of other cartels, are the consumers who end up paying higher prices.

THE CAUSE OF THE CURRENT DISPUTE

While the U.S. government agrees that the Japanese government has enforced the anti-dumping agreement on computer chips sent to the U.S., Washington maintains that private Japanese firms are still dumping chips in third markets,, and that these chips then enter the U.S. as parts in finished products. Further, the U.S. government contends that despite the cartel agreement, the American share of the Japanese semiconductor market has failed to grow significantly beyond 10 percent. While it appears that the Japanese government has begun to curtail production of computer chips by its companies, the effects have not yet been felt.[4] The evidence therefore indicates that at this time the U.S. charges are true.

In response to these violations of the August cartel agreement, the Reagan Administration has slapped a 100 percent tariff on $300 million worth of Japanese consumer imports such as televisions, computers, air conditioners, and electrical equipment. This decision to retaliate rested on two foundations:

1) Japan had failed to enforce a formal trade agreement. If no action were taken, it was felt, Tokyo would conclude that such agreements meant nothing. Thus whether or not the agreement was wise, a violation has occurred and a firm response seemed necessary.

2) U.S. policy makers are frustrated at the exceedingly slow progress of Japan's trade liberalization. The government of Japan, say almost all observers, has been dragging its feet, delaying access to its markets for as long as possible. Many American policy makers thus believe that the U.S. must take the opportunity of a clear Japanese violation of an agreement to send Tokyo a signal that America is serious about more open markets and will take strong measures in response to Japanese recalcitrance. Failure to do this, reason Administration officials, would offer red meat to those in Congress who wish to enact sweeping protectionist measures.

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2. See "Tokyo Concerned About Setting a Trade Precedent," Financial Times, August 8, 1986, p. 4, for an overview of the problems involved with the agreement.

3. There is no indication that private Japanese semiconductor producers are receiving any subsidy from the Japanese government.

4. Andrew Pollack, "Cuts by Japan Now Spur Fears of Chip Shortage," The New York Times, April 7, 1987, p. D1.

Advocates of retaliation point out that past Japanese government actions intended to liberalize trade have often done little to open markets. U.S. firms often find that as one specific trade barrier is removed, another is encountered. Example: in 1985 the Japanese government supposedly privatized its tobacco monopoly and opened its market to American tobacco products. But the Japanese tax and tariff structure effectively raised the price of imported tobacco products by over 40 percent. Thus after the U.S. government had negotiated access to the Japanese market for U.S. tobacco products, it had to seek removal of yet another barrier which limited U.S. sales.

The microchip agreement embodies a tactic for dealing with this trade problem. By demanding a specific share of the Japanese semiconductor market, the U.S. government established an easily measured standard and left it to the Japanese to take whatever steps were necessary to bring about the agreed result.

ECONOMIC PROBLEMS WITH THE SEMICONDUCTOR CASE

Given a seeming open and shut case, the Reagan Administration's actions against Japan in the computer chip case are intended to demonstrate U.S. determination to open Japanese markets. This then aims at heading off heavily protectionist measures by Congress.

The problem is that dumping is an ambiguous economic concept, involving the business practice of selling below the cost of production, often as an attempt to secure a greater market share. Yet selling below cost, or charging different prices in different markets, can be a legitimate business practice. Many U.S. businesses charge different prices in different parts of the U.S., using profits from sales in one region temporarily to offset losses in another region, to retain market share. Most would be shocked to be accused of dumping.

Plunging Chips. Companies also sell products below the cost of production to liquidate large surpluses, especially if the market price of the product is dropping and supply is increasing. This seems to be in part the case with Japanese microchips. During the last few years, chip prices have plunged as supplies have increased and production methods have become more efficient. In certain lines of chips, U.S. producers have not been able to meet the competition. Meanwhile, the Japanese, while competitive, have found themselves with large surpluses of the older lines of chips, such as 64K and 256K RAM chips. With prices falling, it is not surprising that Japanese producers try to dump their chips at a low price.

Even if the chips are selling below the costs of production, it may have been a Japanese defensive action to deal with a falling market--the chips likely would not sell at all if the true production cost were charged. Further, the Japanese face stiff competition from low-priced Korean semiconductors. Japanese price increases could thus allow the Koreans to take away Japanese market shares.

Predatory Pricing. The charge has been leveled, of course, that the Japanese companies actually are engaged in predatory pricing practices, in an attempt to monopolize the semiconductor memory chip market. But the alleged dangers from predatory pricing have properly been called into question by the Reagan Administration and U.S. courts regarding U.S. business practices. Example: In the 1986 case of Matsushita Electric Industrial Co. Ltd. vs. Zenith Radio Corp., which concerned the television set industry, the U.S. Supreme Court effectively rejected the possibility that predatory pricing by private companies could lead to a permanent monopoly. If the U.S. does not see a problem with below-cost pricing when private U.S. companies engage in the practice, it is difficult to see why there are such objections when the practice is undertaken by Japanese firms.

The dumping accusation seems especially weak when it entails markets in third countries. If such countries as Taiwan and Hong Kong are open equally to semiconductor trade from the U.S. and Japan, then there are two economic situations possible, neither of which warrant action against Japan. First, if Japanese and U.S. firms are equally efficient, then price cuts by the Japanese could be met by price cuts from the Americans. On the other hand, if American businesses are uncompetitive in third markets, it is hardly the role of the U.S. government to protect them.

U.S. Consumer Gains. Dumping in a third market, moreover, usually benefits the country receiving the cheaply priced products that use the dumped components. Taiwan, Hong Kong, and other countries receiving low-priced Japanese computer chips can cut their production costs. When these are exported to the U.S., the American consumer gains--and so also do many U.S. exporters. For example, the IBM "PC," a product that has accounted for billions of dollars in sales for the American computer giant, contains 60 percent foreign parts, including imported computer chips. If these foreign parts were not available, the PC would have been more costly to produce, reducing IBM sales and exports. Less expensive chips have cut production costs for IBM, allowing the company to compete more effectively with Japanese finished products. Conversely, when Japanese firms began to raise the prices of their semiconductors in the U.S., as a result of the agreement between the two governments, American computer systems firms and software producers encountered rising production costs.

POLITICAL PROBLEMS WITH THE SEMICONDUCTOR AGREEMENT

The political dangers caused by the semiconductor agreement are as serious as the economic. While it is convenient to speak of trade between the U.S. and Japan as though countries or governments traded, this is only a metaphor. Individuals and companies in the U.S. purchase goods and services from individuals and companies in Japan. Free trade between countries means the absence of government restrictions on such transactions. The semiconductor agreement with Japan requires interference in private trade by both the Japanese and U.S. governments.

To increase the U.S. share of the Japanese memory chip market, the Japanese government must somehow compel private Japanese companies to purchase American products, even when these do not suit the price or production needs of these companies. If it is to prevent dumping in either the U.S. or other markets by Japanese companies, the Japanese government must monitor closely exports by its computer firms and enforce strict price controls.

The U.S. thus is demanding that the Japanese exercise the kind of dictatorial control over its private sector that the U.S. would not tolerate in its own market. For instance, it is difficult to imagine Americans accepting demands from Congress that they must cease buying less expensive and better quality imported items and buy American products instead.

An unintended consequence of the semiconductor agreement could be to strengthen the Japanese Ministry for International Trade and Industry (MITI), which enforces the cartel. Currently many Japanese leaders, including Prime Minister Yasuhiro Nakasone, who are trying to open the Japanese market to more U.S. exports run into resistance from MITI bureaucrats--who mistakenly see Japan's economic interests furthered by a closed market. As the agent of enforcement, MITI would be strengthened if Japan renewed its efforts to enforce a probably unenforceable agreement. A stronger MITI would be better able to frustrate future attempts to open further the Japanese market to U.S. goods and services.

The political problems for the U.S. from the computer chip cartel are also serious. For instance, the U.S. government finds itself in the business of determining the "fair market price" of computer chips. This is a dangerous interference in the market and sets a bad precedent for those who fear national industrial planning.

Hong Kong Anger. Further, by attempting to control the prices at which private Japanese businesses sell semiconductors in third countries, the U.S. government gives further ammunition to those who complain about American efforts to enforce its laws beyond its borders. It is easy to understand the anger in the Republic of China or Hong Kong when the U.S. government tries to increase the cost to them of Japanese computer chips.

This resentment is manifested in a suit against the U.S. brought by the Europeans under the provisions of the General Agreement on Tariffs and Trade (GATT). The Europeans point out that the creation of a government enforced international cartel for chips violates GATT trade laws. The U.S. undermines its own attempts to liberalize international trade through the new Uruguay Round of GATT negotiations when it violates fundamental principles of the current agreement.

THE DANGERS OF A TRADE WAR

The U.S.-Japanese semiconductor dispute reminds Americans again what could result from a trade war. The $300 million in punitive tariffs against Japanese goods which increases prices to American consumers and limits supplies, is just the tip of the iceberg. If the agreement is actually enforced, American manufacturer's who employ computer chips in their products will see costs increase and competitiveness decrease. And if Japan retaliates, say against U.S. agricultural products, American exporters will suffer and there will be loud calls for even tougher action against Japan. Such "tit-for-tat" actions could ignite a full trade war that would seriously erode worldwide confidence in the U.S. economy, similar to the reaction following the passage in 1929 of the protectionist Smoot-Hawley Tariff.[5]

Moreover, the claim that tough--albeit protectionist--actions by the White House will head off damaging action by Congress is questionable. There is the strong possibility that if Japan backs down and abides by the cartel agreement, thanks to U.S. protectionism, Congress may conclude that protectionism works.

CONCLUSION

The frustration of the Reagan Administration, the Congress, and American firms over Japanese trade policy is understandable. This is a frustration shared by the rest of the

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5. Milton Friedman, "Outdoing Smoot-Hawley," The Wall Street Journal, April 20, 1987, p. 22.

trading world--developed and undeveloped countries alike. The Reagan Administration has, for once, caught the Japanese in clear violation of an agreement and Washington is taking the opportunity to show that America means business. It is very troubling, however, that the whole dispute centers on a cartel--a practice usually denounced by the U.S. and all others committeed to trade liberalization.

This is the wrong battle over the wrong issue.

Rather than make the chip agreement the pretext for a Kamikazi attack on Japanese exports, the Administration should scrap the semiconductor agreement. Then, to turn a potential policy disaster into a victory, the U.S. should seek a legitimate exchange with Japan. The U.S. would scrap the microchip agreement if the Japanese remove barriers to American telecommunications equipment or beef and citrus products or legal and financial services or construction. If Japan accepts such an exchange, Tokyo must make concrete promises to be fulfilled according to a rigid timetable. The time for Japanese evasions, deceptions, delays, and prevarications is over.

A breakdown in trade relations between Washington and Tokyo would help nobody. Perhaps Washington even should take the first step. But only if Japan--at last--is willing to give free trade the respect it deserves.

Edward L. Hudgins, Ph.D
Walker Fellow in Economics