Asian Studies Center

Backgrounder

The Heritage Foundation · 214 Massachusetts Avenue, N.E. · Washington, D.C. 20002-4999 · (202)546-4400

No. 136

May 26, 1995

AVERTING AN AUTOMOTIVE TRADE WRECK WITH JAPAN

You cannot expect Japan to force its citizens to buy a certain number of American products. That is authoritarianism at its worst and, if the table were turned, it is not something that would be tolerated in this country.... Not only is this bad policy and damaging to consumers, but it is a flagrant violation of GATT, which I strongly supported. This Administration is pushing the U.S. into a trade war. And a trade war between the United States and Japan will be lost by both sides.

—Jack Kemp
Former Congressman and
Secretary of Housing and Urban Development

INTRODUCTION

Japan and the United States are careening toward an automotive trade wreck. President Bill Clinton has threatened Japan with a 100 percent retaliatory tariff on luxury auto imports unless Japanese automakers accede to American demands. Both Japan and the U.S. are planning to file complaints against each other at the World Trade Organization (WTO). Most experts agree that Japan would win its case against the U.S. in the WTO, but the probable consequences for global trade and the Japanese-U.S. strategic partnership could prove devastating. Japan and the U.S. may be heading for a trade war—something that would be disastrous for both sides.

There is a better way to settle trade disputes with Japan: by liberalizing and deregulating Japanese markets. The existing industry-by-industry approach to opening markets, even when successful, disrupts the broad economic and strategic partnership between Japan and the U.S. A more constructive alternative is to negotiate a free trade and investment agreement with Japan that could be implemented fully by the year 2000.

President Clinton's insistence on employing unilateral trade sanctions before presenting America's "nullification and impairment" complaint against Japan at the WTO clearly violates General Agreement on Tariffs and Trade (GATT) rules. Instead of supporting American efforts to open Japanese markets, U.S. trading partners are condemning the Clinton Administration's unilateral action. Clinton's "punishment first, trial later" approach undermines the WTO and the development of internationally accepted rules for open trade for which the United States fought during the Uruguay Round. As the world's largest exporter, American business will suffer the most if Clinton's actions abort the emergence of a rule of law for international trade.

President Clinton and the Republican leadership in Congress should join with Japanese leaders to settle the automotive trade dispute and move rapidly to build a new Japan-U.S. economic partnership. To do this, the U.S. should:

✔ **Accept Japanese proposals that are consistent with free trade principles.** American and Japanese negotiators are close to market opening agreements to liberalize motor vehicle and replacement parts imports. Ambassador Kantor should immediately conclude an agreement based on the proposals Japan has tabled to assure foreign automakers access to Japanese dealers and to deregulate the auto repair market and streamline vehicle certification and registration procedures.

✔ **Drop the American demand for "purchasing quotas" while continuing to encourage Japanese automakers to facilitate original equipment parts imports.** The Clinton Administration's insistence on "purchasing quotas" for American-made original equipment parts from Japanese automakers violates GATT rules. A "purchasing quota" is a victory for government-managed trade over free trade.

✔ **End the industry-by-industry approach and negotiate a comprehensive free trade and investment agreement by the year 2000.** Japan and the U.S. should move up the completion date for the free trade and investment agreement to which both countries agreed at Bogor, Indonesia, on November 15, 1994. Negotiating a free trade agreement would replace divisive industry-by-industry haggling with a more conciliatory approach. Consumers and workers in both countries would benefit from the resulting trade expansion.

THE HIDDEN HAND: JAPAN'S AUTOMOTIVE TRADE PRACTICES

The "Big Three" U.S. automakers—General Motors Corporation, Ford Motor Company, and Chrysler Corporation—dominated the American market until the 1970s. With little import competition, they emphasized style over quality and cost control. Meanwhile, Japanese automakers, led by Toyota Motor Corporation, pioneered "lean production" to improve quality and lower costs. Japanese production innovations such as continuous improvement circles, just-in-time parts delivery, and long-term relationships with parts suppliers and distributors, known as *keiretsu*,[1] revolutionized the industry. When the 1973 and 1979 oil price shocks occurred, Japanese automakers were ready with high-

1 *Keiretsu* refers to the long-term linkages among a variety of companies in Japan to form a hierarchical organization. *Keiretsu* may be horizontal or vertical. A horizontal *keiretsu* is a group of very large companies with common ties to a major bank and united through cross shareholdings, trading relationships, and personnel sharing, e.g. The Mitsui Group. A vertical *keiretsu* is composed of a lead manufacturing company and hundreds of smaller suppliers and distributors dependent upon it, e.g. Toyota Motor Corporation.

quality, fuel efficient cars that American consumers wanted. By 1980, Japanese automakers exported 1.8 million passenger cars, grabbing a 21.2 percent share of the American market away from Detroit.[2]

Under political pressure from Congress and the Reagan Administration, Japan voluntarily cut back its automobile exports to the U.S. in 1980, accepting a "voluntary export restraint" of 2.3 million autos to the American market.[3] This raised the prices of Japanese imports by limiting supply and left American and European automakers free to raise their prices as well. The result: additional profits from American consumers of between \$5.8 billion to \$10.3 billion annually, most of which went to Japanese automakers.[4] To circumvent the voluntary export restraint and insulate themselves from the threat of further protectionism, Japanese automakers in 1982 established assembly operations in the U.S., beginning with Honda Motor Company in Marysville, Ohio. The output from these "transplants" in 1994 was 1.8 million passenger cars, or 27.2 percent of U.S. production.[5]

Having adopted many Japanese production innovations, American automakers and parts suppliers once again are highly competitive in quality and cost. Although American automotive exports to Japan are growing, they remain low. Imports comprise only a 4.6 percent market share of Japan's 6.5 million unit motor vehicle market, with American automakers holding a 1.6 percent share.[6] In 1994, American motor vehicle exports to Japan exceeded \$2 billion or 103,000 units, up 75 percent in value or 70 percent in unit volume over the previous year.[7] Of these exports, 56 percent were from Japanese transplants and 44 percent from the Big Three.[8] In comparison, motor vehicle imports comprise 14 percent of America's 15 million unit market. In 1994, Japanese exports to the U.S. exceeded \$26 billion or 1.8 million units.[9]

Likewise, imports comprise only 2.4 percent of Japan's \$107 billion auto parts market. American parts suppliers hold only a 1.4 percent share of Japan's market. American auto parts exports to Japan in 1994 rose 31 percent from the previous year to \$1.5 billion. In contrast, imports comprise 37 percent of America's \$122 billion auto parts market, with Japanese parts suppliers holding a 12 percent market share.[10]

Motor Vehicle Exports to Japan

Although Japan eliminated formal border restrictions in the 1960s, it still uses a variety of measures to discriminate against foreign motor vehicle imports. The inability of foreign automakers to secure established dealers remains an especially significant barrier to expanding vehicle exports to Japan.

2 American Automobile Manufacturers Association (AAMA) and Ward's Automotive Report.

3 Japan lowered the limit to 1.65 million autos in April 1992.

4 C. Fred Bergsten and Marcus Noland, *Reconcilable Differences?* (Washington, D.C.: Institute for International Economic Studies, 1993), p. 106.

5 American Automobile Manufacturers Association and Ward's Automotive Report, 1995.

6 Japan Auto Importers Association, 1995.

7 Office of United States Trade Representative, 1995.

8 Japan Auto Importers Association, 1995.

9 Office of United States Trade Representative, 1995.

10 *Ibid.*

Japanese automakers incorporate virtually all of their affiliated domestic dealers into their own *keiretsu*. They often own equity shares in these dealers, arrange mortgage loans for showrooms, provide inventory financing, and even share personnel. Although exclusive dealership contracts are no longer permitted,[11] dealers affiliated with one Japanese maker are usually unwilling to carry autos from other makers, domestic or foreign, because of a fear of retribution.[12] Only 7 percent of Japanese dealers sell American brands while 79 percent of U.S. dealers carry Japanese makes.[13] Without established dealers, foreign automakers must make prohibitively expensive investments to create their own networks or settle for a handful of less successful dealers in Japan. Such exclusionary behavior limits imports by preventing foreign makers from achieving economies of scale in adapting and certifying autos for the Japanese market. The result is higher prices for imported motor vehicles. C. Fred Bergsten, Director of the Institute for International Economics and Chairman of the APEC Eminent Persons Group, and Marcus Noland, Research Fellow at the Institute for International Economics, estimate that the tariff rate equivalent for non-tariff barriers to motor vehicle imports into Japan is 70.2 percent.[14]

For many years, Japanese negotiators blamed low motor vehicle import penetration in Japan on the failure of the Big Three to offer products tailored to the Japanese market, particularly vehicles with right-hand drive and engines of less than 2,000 cubic centimeters. While this was true in the past, American automakers, especially Ford, now have more varied product lines in Japan. The Big Three currently offer 102 products in Japan, of which 60 are right-hand drive and 55 have engines less than 2,000 cubic centimeters in size.[15]

Auto Parts Exports to Japan

American automotive parts manufacturers have two distinct complaints against Japan. First, *keiretsu* bonds between Japanese automakers and parts suppliers preclude their American competitors from entering the original equipment[16] parts market. Japanese automakers maintain close and long-term business ties to their parts suppliers through equity investments and other financial, managerial, and technical cooperation. Contracts between automakers and parts suppliers are structured to guarantee high-volume procurement and discourage automakers from switching suppliers. The *keiretsu* system has been a key factor in the success of Japanese automakers.

11 In 1979, the Japanese Fair Trade Commission issued administrative guidance to eliminate exclusive dealership arrangements.

12 A Japanese automaker can exert leverage over its dealers in several ways. Automakers throughout the world affect the profitability of their dealers by the allocation of new vehicles, frequently allocating more units of popular models to increase the sales volume and profit margins of preferred dealers. Moreover, Japanese automakers can exercise leverage over their domestic dealers through a maker's ownership interest and debt financing.

13 Office of United States Trade Representative, 1995.

14 Bergsten and Noland, *Reconcilable Differences?*, p. 184.

15 American Automobile Manufacturers Association, April 27, 1995.

16 There are two distinct auto parts markets. The "original equipment" market is comprised of automakers purchasing parts for building new vehicles. The parts "aftermarket" is comprised of repair garages and the public buying replacement parts after vehicles are sold in dealerships.

Indeed, American automakers are adopting key aspects of the Japanese parts procurement system to increase their own competitiveness. For example, the relationship between Ford Motor Company and Excel Industries, a window manufacturer, is strikingly similar to *keiretsu* ties between Toyota Motor Corporation and its suppliers. Optimal vehicle designs require the proper tradeoffs between glass-forming possibilities and early vehicle concepts. Excel's specialized glass knowledge must be applied early in the design process to control costs and improve vehicle quality. To assure long-term cooperation, Ford has acquired a minority equity interest in Excel and entered into an evergreen purchase contract[17] that guarantees Excel 70 percent of Ford's glass business as long as Excel is competitive in cost and quality.[18]

The second complaint is that a complex web of discriminatory government regulations prevents American auto parts makers from penetrating the Japanese parts aftermarket. These rules channel consumers toward dealers and certain independent garages that have a *keiretsu* relationship with Japanese automakers and their original equipment parts suppliers for repairs.[19] Consequently, "genuine"[20] (Japanese made) parts distributed through a Japanese automaker's regional parts center or an affiliated wholesaler account for 80 percent of all retail parts sales in Japan.

The most important of these regulatory barriers that discriminate against American and other foreign parts makers is Japan's rigid motor vehicle inspection system, known as the *shaken*. Vehicles must be inspected in Japan at the time of purchase. Once purchased, cars and trucks must be reinspected after three years, every two years thereafter for up to ten years, and then every year. Only certified garages and Ministry of Transport (MOT) Land Transport Offices can perform reinspections. The *shaken* forces Japanese consumers to make expensive and often unnecessary repairs. Inspection cost exceeds $1,200 even without a major repair. Rather than pay for costly repairs, the *shaken* system encourages Japanese consumers to trade in their motor vehicles before their third anniversary. Consequently, the average age of motor vehicles and the demand for replacement parts are lower in Japan than in other industrial countries.

Only MOT-certified garages are permitted to perform *shaken* inspections or make many repairs to motor vehicles. Rigid certification requirements cover personnel, facilities, and service equipment. Most certified garages are owned and operated by dealers or otherwise affiliated through *keiretsu* ties to Japanese automakers or parts suppliers. Certified garages usually stock only genuine parts made by Japanese original equipment parts suppliers.

---

17 An evergreen contract has no termination date and thus will stay in force as long as all contracting parties meet their obligations.

18 Jordan D. Lewis, *Partnerships for Profit: Structuring and Managing Strategic Alliances* (New York: Free Press, 1990), pp. 110-114.

19 For a detailed discussion of import-excluding effects of certification and inspection regulations, see "Barriers to Access to the Auto Parts Replacement Market in Japan (Docket No. 301-93)," Comments of Tenneco Automotive to the United States Trade Representative, December 1, 1995.

20 Genuine parts are manufactured by original equipment parts suppliers under a contract with an automaker. In contrast, non-genuine parts are made at the initiative of auto parts makers.

The major distribution channels of non-genuine parts distribution that exist in other industrial countries are blocked in Japan. Since certified garages must provide full service, specialized repair garages, like Midas Muffler or Brako in the U.S., are effectively prohibited from entering the Japanese market. Moreover, certified mechanics may work only at certified garages. Thus, gas stations and other outlets which could supply non-genuine parts cannot hire certified mechanics to perform simple repairs and parts replacements. Unable to make most repairs, gas stations and other outlets do not carry foreign non-genuine parts.

Under Ministry of Transport regulations, if repairs to the motor, transmission, drive train, brakes, steering, shock absorbers, and other parts deemed critical to safety are not performed in a certified garage, they must be inspected at an MOT Land Transport Office within fifteen days. As a practical matter, Japanese consumers invariably choose to have such repairs done at certified garages which stock only Japanese-made genuine parts.

Finally, Ministry of Transport regulations mandate that a vehicle owner submit to a new inspection and pay additional taxes when repairs or parts replacement cause even a slight change in a vehicle's shape or size. Repairs that can alter a vehicle's size by as little as one centimeter necessitate an inspection costing as much as $500. Since installing some non-genuine parts (for example, replacing shock absorbers), even though perfectly safe and functional, may slightly alter a vehicle's dimensions, Japanese consumers are encouraged to purchase only genuine parts made by Japanese parts suppliers.

The web of Japanese regulations harms Japanese consumers as well as American auto parts suppliers and their workers. A 1991 joint study by the U.S. Department of Commerce and the Japanese Ministry of International Trade and Industry found that 68 uninstalled parts were on average 340 percent more expensive in Japan while 66 installed parts were 198 percent more costly.[21] In a speech on March 30, 1995, Ambassador Kantor noted evidence of wide price differentials between replacement parts in Washington, D.C., and Tokyo. For example, a set of shock absorbers costs only $228 in Washington compared to $605 in Tokyo, a difference of 265 percent. Likewise, an American consumer pays $82 for a muffler and tail pipe that cost $200 in Japan, a difference of 244 percent.[22]

THE JAPANESE-U.S. AUTOMOTIVE TALKS

The United States and Japan have pursued various negotiations to open the Japanese market to foreign automakers and automotive parts suppliers. The Reagan Administration initiated the Market-Oriented, Sector Specific (MOSS) negotiations in 1985-1986 to encourage Japanese automakers to develop long-term business relationships with American parts suppliers. Continuing with this policy under the Structural Impediments Initiative (SSI) in 1989-1990, the Bush Administration agreed to a Market-Oriented Coopera-

21 Department of Commerce/Ministry of International Trade and Industry Automotive Parts Price Survey, June 27, 1991. Installed parts refers to parts placed into the motor vehicle by the vendor at the time of purchase; uninstalled parts are carried out of vendor by the consumer.

22 Speech before the Economic Strategy Institute, March 30, 1995.

tion Plan that was intended to facilitate long-term business ties and increase the purchase of American-made parts. During his ill-fated January 1992 trip to Japan, President George Bush "accepted" an agreement from Japanese automakers, brokered by the Japanese government, to set "voluntary" targets for purchasing $19 billion of parts from American suppliers by 1994.

The Clinton Administration has made automobiles and auto parts a high priority. On July 10, 1993, President Clinton launched a new set of talks called the United States-Japan Framework for a New Economic Partnership. Negotiations were suspended on February 11, 1994, when then Japanese Prime Minister Morihiro Hosokawa rejected Clinton's demand for "quantitative targets" for American exports to Japan. The Framework talks were resumed on May 24, 1994, after the Clinton Administration softened its demand from "quantitative targets" to "objective indicators." On October 1, 1994, the United States and Japan reached significant agreements on several outstanding issues, including telecommunications, medical technology, flat glass, and insurance. However, because auto and auto parts remained unresolved, the Office of the U.S. Trade Representative initiated a Section 301 investigation into the negative impact of Japanese government regulations on American automotive parts suppliers.

Section 301 and the World Trade Organization

Section 301 is a controversial section of American trade law that authorizes the President to impose unilateral sanctions on other countries when the USTR determines that they have engaged in unjustifiable or unreasonable trade practices.[23] Enacted as part of the Trade Act of 1974, Section 301 has been modified significantly by the Trade Agreement Act of 1979, the Trade and Tariff Act of 1984, and the Omnibus Trade and Competitiveness Act of 1988. Section 301 defines an "unjustifiable" trade practice as one that violates GATT or other trade agreements or otherwise nullifies or impairs expected U.S. benefits under those agreements and burdens U.S. commerce. An "unreasonable" trade practice is defined as "not necessarily in violation of or inconsistent with" U.S. legal rights but "otherwise deemed to be unfair and inequitable." An interested party may file a petition seeking an investigation of an allegedly unjustifiable or unreasonable trade practice with the Office of the USTR. If the petition is found to be credible, the USTR must initiate an investigation and seek consultations with the appropriate foreign government. The USTR may also initiate an investigation on its own authority. If the USTR cannot reach a satisfactory resolution of the allegedly unjustifiable or unreasonable trade practice with the foreign government, there must be a hearing on the petition.[24] If an allegation is determined to be valid, the President must impose retaliatory trade sanctions in unjustifiable cases[25] and may impose them in unreasonable cases.

23 For a discussion of Section 301, see Thomas O. Bayard and Kimberly Ann Elliot, *Reciprocity and Retaliation in U.S. Trade Policy* (Washington, D.C.: Institute for International Economics, 1994), pp. 24-32.

24 Hearings and determination must be completed within six months for intellectual property rights petitions, twelve months for subsidies code and bilateral cases, and eighteen months for GATT and other trade agreement violations cases.

25 Loopholes allow a President to avoid "mandatory" retaliation if a foreign government is taking satisfactory measures to eliminate the unjustifiable trade practice, if retaliation would harm national security, or if retaliation would harm the U.S. economy significantly.

The policy undergirding Section 301 was labeled "aggressive unilateralism" by Jagdish Bhagwati, a Visiting Scholar at the American Enterprise Institute and Arthur Lehman Professor of Economics at Columbia University.[26] Since 1985, the U.S. has urged its trading partners to remove barriers to American exports and investment under the threat of retaliatory trade sanctions. This policy is unilateral because the U.S. government alone decides what foreign trading practices are unfair and because it requires its partners to liberalize without any reciprocal concessions.

Establishment of the Dispute Settlement Body in the WTO has changed the economic and political environment surrounding the Framework automotive talks. One of the chief objectives of American negotiations in the Uruguay Round was to devise an effective dispute settlement mechanism. The U.S. government complained that the pre-Uruguay Round GATT dispute panels took too long, allowed any country (including one found in violation) to block them and prevent retaliation, and failed to ensure compliance with their decisions. The new WTO Dispute Settlement Body expedites decision-making, institutes an appeal procedure, and requires a consensus of all WTO members to block panels and prevent retaliation. Under this new system, the U.S. government may continue to use Section 301 to bring cases before the WTO and implement retaliation if foreign governments fail to comply with WTO rulings. However, the U.S. government may no longer impose retaliatory trade

WTO DISPUTE TIMELINE

May 10, 1995
U.S. government notifies the WTO of U.S. plans to file a complaint alleging unfair Japanese trading practices.

May 17, 1995
Japan requests urgent consultations prior to filing its own complaint at the WTO.

June 1995
After filing complaint, U.S. asks for bilateral consultations with Japan. If there is no resolution with 60 days—or sooner if both sides agree—U.S. may ask the WTO's Dispute Settlement Body (DSB) to establish an independent panel. Japanese and U.S. cases will be consolidated.

July - September 1995
DSB must establish a panel and have it operating with 30 days. Panel then has up to 6 months (3 months in urgent cases) to rule.

November 1995 - Spring 1996
Ruling issued.

December 1995 - Summer 1996
DSB must adopt panel report unless there is a consensus against it. But either side may appeal.

Early 1996 - Autumn 1996
Appellate body has 60 days to pass judgment, and DSB has another 30 days to adopt it.

December 1995 - Autumn 1996
If Japan is found in violation of its WTO obligations, Japan would have a reasonable period of time to implement changes. If Japan fails to do so by the deadline, then the U.S. can legally retaliate.

Source: *Financial Times*

26 See Jagdish Bhagwati, "Aggressive Unilateralism: An Overview," in Bhagwati and Patrick, eds., *Aggressive Unilateralism: America's 301 Trade Policy and the World Trading System* (Ann Arbor: University of Michigan Press, 1990).

sanctions unilaterally in disputes arising under the WTO, although it remains free to act unilaterally in disputes outside of the WTO's scope.[27]

Clinton's Framework Negotiations

The Clinton Administration's first goal in the Framework negotiations is to press Japan to end exclusionary motor vehicle distribution practices and encourage Japanese dealers to sell foreign cars and trucks. American negotiators are asking the Japanese Fair Trade Commission (JFTC)[28] and Japanese automakers to reaffirm publicly that Japanese auto dealers may carry more than one automaker's product. The Americans want the JFTC to establish an ombudsman's office to investigate allegations of dealer coercion and the Ministry of International Trade and Industry to encourage major dealers to contact foreign automakers. The Americans also demand that Japanese automakers designate a high level executive as a contact to resolve problems and ensure that their dealers feel free to carry foreign vehicles.

In addition, the Clinton Administration is pressing Japanese automakers to commit to new "voluntary" targets for purchasing American auto parts when the Bush quotas expire this year. Ministry of International Trade and Industry officials feel the "voluntary" targets were a mistake and want to prevent such numerical targets from becoming a precedent, particularly in next year's semiconductor agreement talks. Therefore, the Japanese government has refused to negotiate about what it regards as the business decisions of private companies.

Despite pressure from U.S. Ambassador to Japan Walter Mondale, Japanese automakers adamantly oppose the renewal of such targets. According to the Japanese Auto Manufacturers Association, "The Administration's demands are for quotas, pure and simple.... In a free market system, you can't demand that companies buy supplies according to government expectations."[29] Japanese automakers may be willing to increase their purchases of American-made parts without targets to cope with the rising yen. On May 10, 1995, an unnamed Toyota executive announced that his company is studying a plan to announce new and higher auto parts purchases if the U.S. agrees to treat them as purely voluntary.[30] However, Japanese automakers are under tremendous government pressure not to make any concessions.[31]

As for replacement auto parts, the Clinton Administration is emphasizing deregulation rather quantitative targets. On November 11, 1994, it tabled deregulation proposals covering the automotive sector. The U.S. negotiators want Japan to:

---

27 Jeffrey J. Schott, *The Uruguay Round: An Assessment* (Washington, D.C.: Institute for International Economics, 1994), pp. 125-132.

28 Like the Federal Trade Commission and the Antitrust Division of the U.S. Department of Justice, the Japanese Fair Trade Commission administers competition law.

29 "Kantor Announces Resumption of Auto Talks, Saying He Wants Speedy Result," *Japan Digest*, March 24, 1995, p. 3.

30 "Toyota May Break Ranks, Announce New Parts Purchase Targets Through 1998," *Japan Digest*, May 10, 1995, pp. 3-4.

31 "Report Suggests Automakers Would Deal, But Hashimoto Is Blocking It," *Japan Digest*, April 20, 1995, pp. 1-2.

- ✔ **"Accept equipment standards**... that are the functional equivalent of Japanese standards, and remove standards that serve no important environmental or safety purpose;
- ✔ **"Eliminate the requirement that repairs by non-certified garages**...be inspected at MOT Land Transport Offices;
- ✔ **"Ease the regulations that independent repair shops and mechanics must meet** to be certified to perform all motor vehicle repairs and *shaken* inspections; and
- ✔ **"Revise and liberalize regulations regarding repairs for motor vehicles,** [for example]: [e]liminate the Road Transport Law which requires overhaul inspection of vehicles when only minor changes are made."[32]

Recent sharp exchanges between Kantor and Hashimoto have exacerbated the automotive trade dispute with Japan. In a March 17, 1995, letter, Hashimoto warned Kantor that the U.S. would violate international trade law if it "requests the Japanese auto companies to increase their purchase of particular auto parts in a *de facto* coercive or discriminatory manner."[33] Hashimoto threatened to challenge any U.S. retaliation under Section 301 as a violation of GATT. In a March 19 letter, Kantor responded by threatening "a broad inquiry into Japan's lack of effective adherence to the market opening objectives of the WTO."[34] Kantor further demanded an agreement by Japanese auto makers to purchase "a minimum amount of foreign parts."[35]

On April 12, the White House National Economic Council warned Japan that the Clinton Administration had decided to impose punitive tariffs of up to 100 percent on up to $9 billion of Japanese imports unless Japan agreed to an acceptable automotive market liberalization plan by May 5, the last day of trade ministerial talks in Whistler, British Columbia. The retaliation list would be published later, allowing thirty days for public comments and last-minute negotiations before imposing trade sanctions.[36]

The Clinton Administration apparently is willing to risk a major confrontation with Japan over the automotive market. With a high yen undermining the competitiveness of many Japanese companies, Administration officials believe the rising value of the yen will force the Murayama government to liberalize imports. Subcabinet level automotive talks between the Americans and the Japanese broke off on April 18 without reaching any conclusion. Japanese negotiators rebuffed the American demand that broad-based deregulation of the Japanese automotive sector must be the basis for any solution.

In a last-ditch effort to reach a settlement, Ambassador Kantor and Minister Hashimoto negotiated off and on for three days at the Quad (Canada, European Union, Japan, and United States) trade ministers meeting in British Columbia. Japanese negotiators ta-

---

32 "U.S. Tables Comprehensive Proposal for Deregulation in Japan," *Inside U.S. Trade: Special Report*, November 18, 1994, pp. S3-S4.

33 "Kantor Warns Japan of Broad Trade Challenge Over Auto Dispute," *Inside U.S. Trade*, March 24, 1995, pp. 1 and 17.

34 *Ibid.*

35 *Ibid.*

36 David E. Sanger, "U.S. Plans to Threaten Japan with Tariffs in Trade Dispute," *The New York Times*, April 13, 1995, pp. A1 and D7.

bled new proposals on replacement auto parts and motor vehicle imports. For the parts aftermarket, Japan offered to reduce the scope of the critical parts list, ease *shaken* inspection requirements, and simplify garage certification requirements but did not address American demands to separate auto inspection from repair facilities and permit specialty garages. Japan rejected U.S. demands that Japanese automakers designate an ombudsman to ensure that affiliated dealers are free to carry foreign autos. However, both sides remain far apart on American insistence that Japanese automakers issue specific goals for purchasing American-made parts.[37]

With no movement on this key item, Ambassador Kantor broke off automotive talks with Minister Hashimoto on May 5. On May 6, following the collapse of the automotive talks, Kantor met with Chairwoman Laura Tyson and the other members of the National Economic Council and submitted recommendations to President Clinton before he left for the Moscow Summit. On May 10, Kantor announced that, under Section 301, he had determined that Japan has engaged in "acts, practices, and policies" with respect to the aftermarket for replacement auto parts "that are unreasonable and burden and restrict United States commerce." Kantor proclaimed that the U.S. government had notified the World Trade Organization of its intention to file a broad-based complaint against Japan within 45 days. The U.S. will charge under Article XXIII of GATT that Japan's domestic regulations and *keiretsu* business structures "nullified and impaired" the expected benefits which should have accrued to the U.S. as a result of GATT.

On May 16, Kantor finally announced the preliminary list of trade sanctions. The tariff will rise from 2.5 percent to 100 percent on thirteen models of Japanese luxury passenger cars.[38] In 1994, Japanese automakers exported 209,520 of the affected vehicles to the U.S. with a value of approximately $5.9 billion. These exports represent 12.5 percent of Japan's total vehicle exports to the U.S. by unit volume and 20 percent by value. The final decision on imposing these sanctions will be made on June 28, but the higher tariff will apply retroactively to all vehicles imported after May 19.[39]

The Clinton Administration's apparent strategy is to inflict enough financial pain by "driving brands off the market" to force Japanese automakers to defy the Ministry of International Trade and Industry and agree to parts purchasing targets.[40] Indeed, Nikko Research Analyst Noriyuki Matsushima noted that the sanctions would cause Japanese automakers to "plunge deeply in the red in exports....These cars have been their main source of profits and have been making up for the losses coming from their lower-class cars."[41]

Foreign reactions to these sanctions were negative. In Tokyo, Minister Hashimoto accused the Clinton Administration of imposing "numerical targets...under the threat of unilateral actions, which is nothing but government intervention in private business ac-

---

37 "U.S., Japan Try to Settle Voluntary Parts Plan Issue," *Inside U.S. Trade*, May 5, 1995, pp. 1, 18-19.

38 Acura Legend, Acura 3.2 TL, Lexus LS 400, Lexus SC 400, Lexus SC 300, Lexus GS 300, Lexus ES 300, Infiniti Q45, Infiniti J30, Infiniti I30, Mazda 929, Mazda Millenia, and Mitsubishi Diamante.

39 Statement of Ambassador Kantor, Office of United States Trade Representative, May 16, 1995.

40 "Kantor Makes Sanctions Effective Saturday: Both Praise and Rebukes," *Japan Digest*, May 17, 1995, p. 1.

41 "Sanctions' Real Impact on Makers, Dealers Is Unclear," *Japan Digest*, May 17, 1995, p. 2.

JAPANESE LUXURY CAR IMPORTS HIT BY SECTION 301 SANCTIONS

Make & Model	U.S. Sales in 1994	Base Sticker Price in 1995
Honda		
Acura Legend	35,709	$30,890
Acura 3.2	Introduced in 1995	$27,900
Toyota		
Lexus LS 400	22,443	$51,680
Lexus SC 400	7,392	$48,880
Lexus GS 300	13,939	$43,180
Lexus SC 300	4,537	$41,380
Lexus ES 300	39,108	$31,980
Nissan		
Infiniti Q45	11,949	$52,850
Infiniti J30	22,718	$39,000
Infiniti I30	Introduced in 1995	$31,000
Mazda		
929	9,206	$36,235
Millenia	24,423	$26,435
Mitsubishi		
Diamante	18,096	$28,720

Sources: Office of the United States Trade Representative, Ward's Automotive Reports.

tivities, and poses a serious threat to the free trade system."[42] Hashimoto warned that Japan may retaliate against American products if the sanctions are implemented.[43] Privately, Japanese officials charged that a weakened President Clinton is taking a hard line against Japan solely for political reasons.[44] European Union Trade Commissioner Leon Brittan noted that these "measures, if implemented would be contrary to U.S. obligations under the WTO."[45] WTO Director-General Renato Ruggiero bluntly warned, "In reality, what is now at stake is not the functioning of the World Trade Organization, but the credibility of the engagements freely entered into by these parties."[46]

42 David E. Sanger, "100% Tariffs Set on 13 Top Models of Japanese Cars: $5.9 Billion Sales," *The New York Times*, May 17, 1995, p. A1.

43 Martha M. Hamilton, "U.S. Targets Japan's Luxury Cars," *The Washington Post*, May 17, 1995, p. A28.

44 Sanger, "100% Tariffs."

45 "Kantor Makes Sanctions Effective Saturday."

46 "Ruggiero Demands Respect for WTO Rules," *Financial Times*, May 17, 1995, p. 8.

The American complaint and the Japanese counter-complaint will pose a serious challenge to the WTO's untested Dispute Settlement Body. Of these two cases, the outcome of the American complaint is more difficult to predict. The Japanese will argue narrowly that America's unilateral imposition of trade sanctions violates GATT provisions that WTO members must present their allegations of trade infractions and win authorization from the Dispute Settlement Body before imposing trade sanctions. University of Michigan law professor John Jackson described the Japanese case as a "cold, flat-out easy case."[47] On the other hand, rather than charge Japan with a specific violation of GATT rules, the U.S. will accuse it of "nullifying and impairing" the expected benefits in automotive trade. The American case will plow new legal ground for a dispute-settlement panel, especially since the allegedly unfair practices were in place well before the Uruguay Round was ratified in 1994.[48] Professor Jackson feels the U.S. may well win its case, but how the WTO panel will rule is not certain.[49]

On May 17, Japan followed through on its threat by taking the first step toward bringing its own complaint against the U.S. before the WTO. Japan is charging the U.S. with three violations. First, Japan will argue that the American sanctions violate Article I of GATT by denying Japan Most Favored Nation treatment and Article II of GATT by raising tariffs above those bound in the American schedule of tariff concessions. Japan will argue also that the American sanctions violate Article XXIII of the WTO Dispute Settlement Understanding, which "prohibits any contracting party to make a unilateral determination on remedial measures."[50]

THE DEMISE OF JAPAN, INC.

The U.S.-Japanese trade dispute must be seen against the backdrop of the economic crisis in Japan. Understanding this crisis can help provide an answer to the U.S.-Japan trade dispute.

Japan is enduring a financial crisis caused by monetary mismanagement, excessive regulation, and protectionism. Unless Japan adopts a more expansive monetary policy, radically deregulates its domestic markets, and liberalizes its international trade practices, the Japanese economy will wither and perhaps trigger a world-wide recession. While burdensome regulation and protectionism did not cause the current financial crisis in Japan, they aggravate the economic downturn and impede a quick recovery. Deregulation and trade liberalization would ameliorate this crisis and might keep the Japanese recession from spreading to the U.S. and other economies.

The current financial crisis began with a monetary overreaction to an external shock. The Bank of Japan's overly lenient monetary policy spurred Japanese banks to expand credit rapidly. Between 1985 and 1990, outstanding loans at all Japanese banks grew an average of 17.2 percent,[51] compared to an average nominal gross domestic product

---

47 Bob Davis, "U.S. Launches Trade Offensive Against Japan," *The Wall Street Journal*, May 11, 1995, p. A-2.

48 Some legal scholars think the "nullification and impairment" clause may be prospective only. Long-standing trade practices that do not directly violate GATT (1994) may not be within the jurisdiction of the Dispute Settlement Body.

49 Davis, "U.S. Launches Trade Offensive."

50 "Japan to Challenge U.S. in WTO with Violation of MFN, Bound Tariffs," *Inside U.S. Trade*, May 17, 1995, p. 2.

growth rate of 6.7 percent.[52] The credit explosion produced a sharp escalation of real estate and stock prices, and banks made new mortgage loans on the speculative assumption that real estates prices would continue to rise. Simultaneously, as equity prices rose, many industrial companies issued new stock to raise funds to speculate on real estate and other equities. The speculative bubble reached its zenith at the beginning of 1990.

As a result, Japan's economy is in deep trouble. The Nikkei stock index has declined 58 percent from a peak of 39,915 on December 31, 1989, to 16,462 on May 11, 1995. Average real estate prices have declined by nearly one-third during the last four years, and this trend appears to be accelerating. Mark Brown, property analyst for Barclays de Zoete Wedd in Tokyo, estimates that Tokyo commercial and residential property prices fell by 25 percent and 15 percent, respectively, for the Japanese fiscal year[53] ending March 31, 1995.[54] The rising yen has eroded the value of overseas investments, denominated in other currencies, that were made by Japanese mutual funds, insurance companies, and pension funds during the 1980s.

The Japanese economy has been flat for four years. Economic growth decelerated in 1991, and the economy slipped into recession in 1993. Real gross domestic product grew by 1.1 percent in 1992, fell by 0.2 percent in 1993, and edged up by 0.6 percent in 1994.[55] The resulting recession has had an adverse impact on industrial production, which fell 8 percent from 1990 to 1994.[56]

There are signs that Japan's banking industry is weakening. Declining asset values are undermining the solvency of Japanese banks. In stark language, the Director of the Bank of Japan's Financial and Payments System Department, Minoru Masubuchi, has warned that, "As an after effect of Japan's bubble economy, the entire financial sector is faced with a huge amount of problem loans.

Deflation, previously confined to real estate and financial assets, is spreading throughout the Japanese economy. Japan's wholesale price index declined 1.4 percent in fiscal 1994, after falling 1.8 percent in the previous year, while its consumer price index inched up 0.5 percent. However, economists widely acknowledge that the Japanese consumer price index overstates the inflation rate because it excludes discount retailers and house brands from the price survey. The actual deflation rate for consumer prices in fiscal 1994 was probably between minus 1 percent and minus 2 percent. Japanese business owners fear price deflation will trigger a recession.[57]

---

51 Research and Statistic Department, Bank of Japan.

52 Economic Research Institute, Economic Planning Agency.

53 The Japanese government and all Japanese businesses use a common fiscal year (JFY) beginning on April 1 and ending on March 31 of the following year. A JFY bears the number of the calendar year in which it begins.

54 William Dawkins, "A Lesson from the OECD," *Financial Times*, March 31, 1995, p. 5.

55 Economic Research Institute, Economic Planning Agency.

56 Ministry of International Trade and Industry.

57 Michael Williams and Norihiko Shirouzu, "Japanese Worry Deflation Could Trigger a Recession," *The Asian Wall Street Journal Weekly*, May 1, 1995, p. 15.

Japan may be on the verge of a financial depression. Although the Bank of Japan cut its official discount rate by 0.75 percent to a post-war low of 1.00 percent on April 14, 1995, and commercial loan rates for prime customers hover around 3 percent, deflation means real interest rates are much higher than nominal interest rates. Real commercial loan rates are now at least 5 percent.

Japan is in a vicious economic cycle. When any country maintains a large current account surplus[58] over many years, the exchange value of its currency will rise unless offset by large voluntary capital outflows. Diminished capital exports and a restrictive monetary policy are pushing the exchange value of the yen ever higher. In principle, a higher exchange value for the yen should increase imports, curb exports, and thereby reduce the current account surplus. However, Japan's highly regulated and protected markets inhibit the rapid rise in imports that would be expected from a highly valued currency if the economy were more open—i.e., less regulated and protected from overseas markets.

The only way Japan can break this vicious economic cycle is through an immediate and comprehensive program of deregulation and trade liberalization. The business community in Japan recognizes that deregulation and trade liberalization are the keys to economic survival. In April, Shoichiro Toyoda, Chairman of both Toyota Motor Corporation and the *Keidanren* (Federation of Economic Organizations), declared that "Sweeping regulatory reform—including the abolition of non-tariff barriers is absolutely essential.... We need to strike off the regulatory chains shackling the Japanese economy."[59] The Murayama government concedes that something must be done to deregulate the Japanese economy, but its proposed five-year deregulation plan, released on March 31, 1995, is timid. Kantor charged on April 1 that it "falls far short of the comprehensive deregulation objectives set out by the Japanese government last year."[60]

AVERTING AN AUTOMOTIVE TRADE WRECK

The United States and Japan must avoid an automotive trade wreck. The disruption costs to both economies are simply too high. To avoid this outcome, the United States should:

✔ **Accept Japanese proposals that are consistent with free trade principles.** American and Japanese negotiators are close to an agreement in regard to the distribution of new motor vehicles. Given the movement of Japanese negotiators, Japan and the U.S. should be able to agree on a broad-based aftermarket deregulation. Japanese business leaders are demanding that their government implement a comprehensive deregulation program. The *Keidanren*'s own deregulation proposals for auto repairs, inspections, and garage certification are similar to those proposed by the Clinton Administration. American proposals for deregulating auto repair, inspection, and

58 The current account is the sum of the merchandise trade balance, the service trade balance, net investment income flows, and government payments to and receipts from abroad. By definition, the current account balance, the capital account balance, and net gold and other reserve asset movements must sum to zero.

59 Toyota Motor Corporation, April 25, 1995.

60 "Brittan Says He Likes Tokyo's Deregulation Plan; Kantor Dismisses It," *Japan Digest*, April 5, 1995, p. 1.

certification would increase convenience and lower repair costs for Japanese consumers while expanding market opportunities for American auto parts suppliers.

- ✔ **Drop the demand for "purchasing quotas" while continuing to encourage Japanese automakers to facilitate original equipment parts imports.** Renewing the commitment of Japanese automakers to "voluntary" purchasing targets for American-made auto parts is the most troublesome issue in these negotiations. Establishing new quantitative restrictions, whether voluntary export restraints or voluntary export expansions, is contrary to GATT. Japan is right to oppose numerical targets. However, Japanese automakers could ease trade tensions without agreeing to purchasing quotas by demonstrating that they are willing to buy competitive American auto parts. For example, they could compile their own public statements and automotive trade press reports about expanding facilities and increasing parts purchases in the U.S. By giving American parts suppliers public notice of marketing opportunities, Japanese automakers can build confidence without being locked into purchasing quotas.

- ✔ **End the industry-by-industry approach and negotiate a comprehensive free trade and investment agreement with Japan by the year 2000.** While some economic nationalists in the United States may take perverse satisfaction in a Japanese economic meltdown, they should consider the costs to the American economy. A Japanese depression would reverberate through the global economy and severely affect American businesses and their workers. The American and Japanese economies are fundamentally intertwined; a recession in one will likely spread to the other. Despite Japanese trade restrictions, U.S. companies exported $54 billion of goods to Japan in 1994, employing approximately 1.1 million Americans.[61] What would happen to these firms and their workers if the Japanese economy collapsed? "Beggar thy neighbor policies" will work no better in the 1990s than they did in the 1930s. It is in America's national interest to encourage Japan to deregulate and dismantle structural trade barriers that threaten its economic viability.

President Clinton must move beyond haggling with the Japanese and offer them a new vision for economic cooperation. Clinton and Prime Minister Murayama have already agreed to the goal of "free and open trade in Asia Pacific no later than the year 2020." For developed countries, the date is a decade earlier, in 2010. This pledge was made in a "Declaration of Common Resolve" at the Leaders' Meeting of the Asia-Pacific Economic Cooperation (APEC) forum in Bogor, Indonesia, on November 15, 1994. President Clinton should join the Republican leadership in Congress to challenge the Japanese and offer them a broad free trade and investment agreement with the United States by the year 2000. The American and Japanese governments should develop mutually fair and transparent rules for open markets. An agreement between Japan and the U.S. must go beyond such border measures as tariffs and quotas and address the differences in many domestic laws and regulations as well. It should liberalize highly regulated markets in both countries and eliminate regulations that have a discriminatory impact on trade and investment.

61 *1995 National Trade Estimate on Foreign Trade Barriers*, United States Trade Representative, March 31, 1995, p. 163.

Conclusion

The United States and Japan are on a collision course in the automotive trade talks. However, a trade wreck can be averted if negotiators agree to the principles of deregulation and fair rules for open automotive markets. Once the automotive talks are concluded, the Clinton Administration and the Republican leadership in Congress should re-evaluate the industry-by-industry approach to trade negotiations with Japan. A more constructive approach would be for the two countries to form a comprehensive free trade and investment agreement. Japan and the U.S. should not wait until 2010 to achieve free trade and investment under APEC. They should begin working now.

Robert P. O'Quinn
Policy Analyst