THE MANAGEMENT OF THE UNITED STATES-JAPAN TRADE RELATIONSHIP AND ITS IMPLICATIONS FOR THE PACIFIC BASIN ECONOMIES

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I. Overview

The United States-Japan trade relationship is of major importance to both countries, to the other economies of the Pacific Basin, and to the world economy and its international trading system. While providing immense economic benefits, it has also generated increasing bilateral tension and contentious friction to a degree which has profound implications bilaterally, regionally, and globally. The trade relationship has become highly politicized in both countries, especially the United States, and increasingly difficult to manage effectively at the governmental level.

The fundamental issues are: will the ways in which the United States and Japan handle their own economies and particularly the bilateral tensions in trade bring down the international trading system as we know it, or less extremely transform it in major ways to a substantially less open system? Will the United States, Japan, the Pacific Basin region, and indeed the world economy sink either into recession or head into substantial inflation, or first recession and then inflation in reaction?

This is a short paper, the goals of which are nonetheless comprehensive. It focuses on the three main dimensions of the U.S.-Japan trade relationship: macroeconomic, namely the overall immense respective trade and
current account deficits and surpluses; microeconomic, namely sectoral issues of American business access to Japanese markets (and, less marred by bilateral frictions but of systemic importance, the nature of restrictions of Japanese access to U.S. markets); and systemic, namely the way in which the resolution of bilateral trade issues affect the rules of the game and nature of the GATT-based, multilateral, relatively open international trading system. I briefly assess recent trends and their causes, current policy issues and actions, and draw important implications. In the final section I consider the effects on other Pacific Basin economies; that discussion in relevant for the world as a while though the management of the U.S.-Japan trade relationship has a particularly large Pacific Basin impact.

The importance of the trading relationship lies not simply in its huge size -- after all U.S.-Canada trade is substantially greater though for Japan the United States is by far its largest trading partner -- but also in its nature. There are two major economic factors. First, Japanese firms have become the dominant competitive challenges to American firms in a number of major industries -- first textiles, then steel, automobiles, and now semiconductors and potentially other civilian goods high technology sectors. American problems of structural adjustment have been severe, and major politically powerful industries have been able to use the political process to prevent a purely market-determined solution.

Second, Japan by virtue of its economic size (second largest market-economy GNP since the early 1970s), attainment of the technological frontiers in manufacturing, and high standard of living -- having "caught
up with the West" economically and technologically by the late 1970s -- is an economic power second only to the United States. As such it has not only a major stake in maintaining the open international trading system but a major responsibility to assure that the system is strengthened and expanded, not weakened. This is the key issue of the leadership role of Japan as a major economic power.

Perhaps not surprisingly, discussion focuses on the problems and frictions in the bilateral trading relationship while the actual benefits accruing to individuals and companies in both countries tend to be taken for granted or downplayed. We should not forget that consumers have a greater variety of goods, and at lower prices, to select from. Producers and marketers using imported components, OEM products, or intermediate imports similarly benefit. Long-run economic performance in both countries has been enhanced by the spur of competition and more efficient resource allocation; export producers have benefitted from growing markets. The main losers, far larger and more noticeable in the United States than in Japan, have been domestic producers facing severe competition from Japanese (and other, especially Pacific Basin) imports. The domestic politics of trade pit highly organized domestic producers facing import competition (workers, managers, and owners in steel, automobiles, textiles in the U.S.; farmers, small-scale retailers, and those in textiles, aluminum and similar uncompetitive sectors in Japan) against diffuse consumers who count very indirectly if at all in the practical politics of the management of the U.S.-Japan trade relationship and against somewhat better organized export producer interest groups (especially in Japan).
There are two further dimensions which add to the importance and also the complexity of the economic relationship. First, the newly emerging bilateral financial relationship inevitably will have to have a major impact. The United States has already become the world's largest debtor nation, and Japan the largest creditor, and more than two-thirds of Japanese credits are in American (or at least dollar-denominated) assets. Inevitably the rise of these respective net debtor and creditor positions, and Japanese net (portfolio and direct) investment will increase dramatically in the next five years, in ever more complex patterns and with new and special particular problems for the management of the U.S.-Japan relationship. Second, the United States and Japan have a security treaty of great importance to both nations. This security relationship of necessity frames the environment within which economic issues between the two countries are dealt with. In many respects the bilateral relationship is a symbiotic alliance with its core built upon the three pillars of security, trade, and, increasingly, finance and capital flows.

The United States and Japan are the dominant economic forces in the Pacific Basin by virtue of their economic sizes, technological capabilities, trading patterns, and roles in determining and maintaining the rules of the game of the trading system. Not only U.S. and Japanese economic performance and policies, but the ways in which the bilateral relationship is managed strongly affect the other Pacific Basin economies -- to their advantage or to their disadvantage. In general, bilateral negotiations to open markets, notably the Japanese, benefit the others though probably not as much as multilateral negotiations would since
reduction of barriers focuses particularly on American interests. Bilateral negotiations to restrict Japanese access to the American market -- essentially for reasons of injury and to ease structural adjustment whatever mechanisms may be used -- can spill over adversely or beneficially to other Pacific Basin economies, usually adversely; notably textiles but also color television are adverse examples. To the degree that other countries can quickly substitute their production and exports for Japanese to the U.S. the effect is beneficial -- but likely to result in eventual restriction of their exports to the United States as well. The central issues for all the Pacific Basin economies are global: will the United States through its unilateral policies become much more protectionist overall, or by sector, and thereby fundamentally reduce the operations of the international trading system and dramatically change the rules of the game? Will Japan really become a responsible leader in the international trading system by reducing its continuing important specific trade barriers? Put more positively, will the GATT system persist and be strengthened, and will Japan be fully integrated into the world economy?

II. The Macro Issues: Huge Merchandise Trade and Current Account Imbalances

The burgeoning overall trade imbalances of the United States and Japan have come to be the dominant source of friction in the bilateral trading relationship. Two of the most important trends in the world economy in the five years since 1981 have been the shift in the United States from a global balance of payments current account surplus of $6 billion in 1981 to a deficit of $141 billion (3.8% of GNP) in 1986, and
concurrently a sharp increase in Japan's current account surplus from $5 billion to $87 billion (4.2% of GNP). (See Table 1.) During this period the U.S. bilateral current account position with Japan -- which has been in deficit anyway for structural reasons of Japan's reliance on raw materials imports and manufactured goods exports and U.S. openness in manufactured imports -- increased from a deficit of $14 billion to about $55 billion (U.S. data not yet available; 1985 was $45 billion). I use the more comprehensive current account measure which combines trade in merchandise and trade in services, as well as unilateral transfers (gifts and remittances). This is important because in the future the U.S. will have to export more goods (or import less) in order to pay the interest and dividends (a service item) on its accumulating net foreign debt; conversely Japan will export less or import more as it earns interest and dividends on its vast foreign assets.

It is essential to understand that, while these two, mirror-image patterns of rising U.S. current account deficit and Japanese surplus are related, the basic causes are domestic in each country and are very different. Japan's surplus is only in part the cause -- or consequence more likely -- of the U.S. deficit, even though the increase in the bilateral deficit is equal to about 28% of the U.S. global deficit increase. Nonetheless, by virtue of its size and salience Japan has become the symbol to many Americans of the foreign source of U.S. trade imbalance problems.

The intolerably huge rise in the U.S. trade deficit has been one of the two most important foreign policy mistakes the United States has made in the past quarter-century; the other was Vietnam. Yet it was an
unintended by-product of a set of domestic macroeconomic policies in 1981-83 which, while halting inflation, increasing American military strength and reducing personal income tax rates, resulted in an increasingly huge Federal budget deficit, internationally high nominal and real interest rates, and an overvalued dollar as foreign capital was attracted in. Put simply, in 1986 the U.S. spent $141 billion more than it produced; it obtained the goods and services needed to fill the gap by imports, and paid for them by borrowing from foreigners especially Japanese.

The September 1985 G-5 agreement and the dollar depreciation and the yen and European currencies appreciation altered the relative price structure between the United States and those countries to make imports less attractive and exports more attractive for the U.S.; but until the basic spending-production gap (investment-savings gap) is narrowed — most readily through reduction in the Federal budget deficit — then the U.S. trade and current account deficit problem will not be resolved. It is a mistake to think that the cause of the overall deficit is the closed market of Japan and other trading partners; their degree of protection has decreased in the past five years, not risen. Moreover, while reducing those barriers and increasing American export access to those markets is highly desirable on its own grounds, it does not constitute the major solution.³ The macroeconomics of global trade imbalances should not be confused with the microeconomics of market access.

The basic cause of Japan's current account surplus is also essentially domestic, though due more to long-run structural factors than government macroeconomic policies. Essentially the surplus derives
from the fact that Japan's private sector saves more than it invests.

The pattern emerged in the early-mid 1970s. Economic growth rates slowed substantially, businessmen considerably invested less (as a share of GNP), while private saving decreased much more modestly and slowly. This structural pattern was masked by the two oil crises. In the latter half of the 1970s, the surplus of private saving over investment was used by the government to finance an expansive expenditure program. However, from 1981 the government has pursued a contractive expenditure and fiscal policy to reduce its budget deficits which were popularly perceived as being dangerous in the long-run. This alone would have resulted in a balance of payments current account surplus on the order of 1-1.5% of GNP, and slower growth. However, at about the same time Japan was provided the fortuitous gift of an overvalued dollar which made it easy for Japan to go onto an export-oriented growth path until 1986. While Japan would have developed a current account surplus, its size would have been substantially smaller in the absence of the huge U.S. global trade deficit.

Japan presently faces a domestic macroeconomic policy dilemma; the choices are politically not easy. As a consequence of yen appreciation -- even greater due to the decline in oil prices from late 1985 -- exports are no longer price competitive and manufactured imports are much more attractive; the economy can no longer rely upon export-led growth. Indeed as the current account surplus first levels off and then decreases from its present excessive levels (as a share of GNP), trade is having a negative effect on growth. What is Japan to do with its surplus savings? Tax reform will not have a significant macroeconomic effect on saving
behavior in either Japan or the United States. Slowed growth -- indeed recession as seems quite possible in 1987 -- reduces savings but at the high cost to Japanese citizens of foregone output, income, and consumption. Monetary policy is less effective in an excess capacity economy. Fiscal expansion -- increases rather than reductions in government deficit financing in the short to medium run -- is the solution, but the Nakasone government and the Ministry of Finance apparently still remain committed to fiscal deficit reduction, not expansion, despite very recent suggestions of an expansive supplementary budget (I think as of this writing the 1987 budget has yet to pass). The long-run benefits of high Japanese savings rates for Japan and for the world are offset by the high short-run costs of slowed growth, structural adjustment problems, and continuing trade friction with the U.S. concerning the size of Japan's bilateral and global trade surplus. Clearly it is in Japan's domestic interests to have good, stable, domestic demand-based growth; it is also important for the world economy. The direct impact on the U.S. trade deficit is in fact small, but the indirect effects via the multilateral trading system are considerably more substantial.

The key bilateral macroeconomic trade issues are: will the U.S. reduce its global trade deficit and if so, by what process? Will Japan achieve a good GNP growth rate -- say 3.5 to 4.5% -- even as its current account surplus decreases? Will the extreme change in the dollar-yen exchange rate relative to the globally traded weighted exchange rate of each currency succeed in reducing the bilateral deficit more than proportionately? Each country must pursue domestic fiscal policies to achieve the objectives of contraction in the U.S. and expansion in Japan.
Nonetheless, given their interdependence and global importance of these two economies, each has a stake in how the other resolves its policy problem, and each will benefit from cooperative solutions. Substantial further yen appreciation and dollar depreciation (vis a vis the yen, though not other currencies whose countries have current account surpluses and which have not appreciated much) is not the optimal adjustment mechanism and probably note even desirable; it would generate recession in Japan and inflation in the United States. Moreover, there are real dangers of the dollar's free fall and hard landing with dire consequences for all.

The optimal timing and pattern of trade imbalance reductions is not clear, nor are equilibrium (or policy target) levels. An American reduction in its global trade deficit on the order of $25-$30 billion annually for the next five years appears attractive; a faster rate may be domestically difficult to achieve (and probably undesirable) and would reduce world trade demand excessively, to the detriment not only of Pacific Basin but all economies. A more modest Japanese reduction of its global trade surplus, say by $10 billion a year might be reasonable, particularly if Japan provides capital to developing countries to maintain existing net trade positions as U.S. demand for their goods decreases.  

A danger is that both countries may mistakenly attempt to resolve their global trade imbalances by direct actions aimed only at each other. It has been suggested that the United States impose a large surcharge on imports from Japan (and a few other countries). That would reduce the U.S. bilateral deficit with Japan, but to a large extent would mean that
imports would simply shift to other countries in the Pacific Basin and elsewhere without reducing the U.S. global trade deficit (as in consumer electronics, for example). Some Japanese leaders have suggested that the only way to deal in the present, ongoing crisis with the United States is to reduce Japanese exports to the United States by direct action -- an export surcharge or export quotas. That too, given Japan's large savings surplus, would mean that Japanese exports would increase in third markets, to some considerable degree at direct expense of competing U.S. exports to those markets. Such bilateral "solutions" are no solution at all: they do not much affect the respective global trade imbalances, they generate inefficiencies in resource allocation, and then undermine the multilateral system of trade adjustment.

III. The Micro Issues: Market Access, Structural Adjustment, and Protectionism

The most important and enduring trade issue in the U.S.-Japan economic relationship has been and will continue to be American business access to the Japanese domestic market, mainly in terms of exports though at times American direct investment or business entry into Japan is of concern. The American government negotiating effort has been two-fold: to seek general reductions in tariffs, quotas, and other official non-tariff barriers through GATT rounds of negotiations or "unilateral" actions by Japan (the series of market-opening packages); and to press for reductions in specific sectors or on specific products (oranges, beef, aluminum bats, cigarettes, the MOSS negotiations; see Table 2 for recent issues). The product-by-product approach has taken the most time; is also used to raise generic issues (government procurement, standards,
private barriers); and has received the most publicity and hence is a major source of ongoing friction. Japan's market opening measures are multilateral and most-favored-nation in principle, though not surprisingly the items are usually of particular interest to American producers.

A secondary bilateral issue (in American perspective at least of the sources of friction) has been to place restrictions, formal or informal, on Japanese access to the very open U.S. market — mainly in politically powerful industries (textiles, steel, automobiles, semiconductors) but at times to help a specific interest while "sending a general signal" and defusing anti-Japanese pressure in Congress (the OMA in color television, the tariff on motorcycles, the April 17, 1987 announcement of prohibitive tariffs on $300 million of Japanese portable and desk-top computers, color television sets, and power hand tools in retaliation for alleged non-performance of the Semiconductor Agreement.) Japan has pragmatically pioneered in the development of a new trade-restrictive instrument, the voluntary export restraint (VER), which the United States has eagerly endorsed. The general American restrictions represent special bilateral deals, outside and contrary to GATT rules; they solve immediate problems but undermine the stated norms and rules of the international trading system. Such arrangements are the only significant way in which the United States Government attempts to deal with the very real and serious problems of structural adjustment of major industries in trouble.

The key issues are: to what degree and how quickly will Japan remove its remaining trade barriers? Will the United States halt its procession of protectionist steps (stand still), and indeed remove
recently imposed barriers (roll-back)? Can the U.S. devise effective, positive mechanisms for solving major industry structural adjustment problems which are not import restrictive?

In both nations these are politically difficult goals, yet essential if the open multilateral trading system is to prevail. Both countries face real problems of structural adjustment in major sectors of large employment (agriculture in Japan, steel in both nations, for example). In certain industries, mainly high tech, issues of competitiveness are complicated by national security concerns and objectives. These are explicit in the U.S.; and quite often American firms use the national security argument for protection without strong or clear justification. The articulation of Japan's national security interests is deliberately opaque and vague, and certainly not strongly stated; recent and prospective actions indicate they are nonetheless real, primarily in terms of maintaining and developing options in high technology sectors with significant potential military application (satellites, supercomputers, telecommunications, the new fighter plane).

A great deal of nonsense has been said in the current debate on the competitiveness (or lack thereof) of American industries. At the macro level the key factors are the exchange rate for price competitiveness, basic and applied R&D, the performance of the education system, and systemic changes in the managerial system and in the system of industrial relations. The exchange rate is especially important in the short-run (and longer if misalignment persists) because it determines where in the competitive ranking of industries the cut-off will be between industries able to compete in export markets and those facing import competition. The 53-88% (trade weighted) dollar overvaluation
made a whole class of normally competitive industries uncompetitive in price terms; dollar devaluation has reversed that course, though probably not yet to the 1980 cut-off point.\footnote{7}

However, competitiveness is also quintessentially a micro phenomenon: how well do individual firms compete in costs, quality, prices, and innovation with their competitors, at home and abroad? The fundamental causes of changes in the competitiveness of specific industries lie in the process of growth -- the relative acquisition of human skills, new technologies, capital formation, management techniques -- not just in the U.S. and Japan but throughout the world. To this theory of comparative advantage one must add the specific features of industrial structure, technological change, development of specific products, and the like which drive trade between countries within the same industry category (intra-industry trade). The global spread of the industrial revolution not only to Japan but now to the NICs is inexorable and inevitable, a reality which American companies must deal with. Japanese and NIC competitiveness is not going to disappear; it will simply move from one sector to another as countries climb the technology-skilled labor-capital formation ladder.

In the case of Japan, over the past fifteen years, its economy and trade policy have moved from highly protected and protectionist to one in which in general official import barriers -- tariffs, quotas, and other non-tariff barriers -- are among the lowest of the industrial nations.\footnote{8} Nonetheless, foreign frustrations -- certainly American, but those of other Pacific Basin economies and the European Community as well -- concerning lack of real access to Japanese markets remain high. There are two major substantive reasons.
First, official barriers remain high in a large number of specific products in which American, or other foreign producers, are very competitive. These include agricultural and other land-based commodities in both raw and processed form (from foodstuffs to timber to cigarettes to chocolate candy); energy-intensive products, such as petrochemicals and refined petroleum products (gasoline); other industrial products (from caustic soda to pharmaceuticals to medical equipment); certain high technology goods (military equipment, satellites, telecommunications equipment); and especially for its Pacific Basin neighbors, labor-intensive manufactures (textiles, footwear). These issues have been handled by U.S. and Japanese negotiators mainly on a product-by-product basis. The products change, but the issues remain. It involves real slogging through the trenches of commercial policy at the micro level. In the past the American agenda of priority items has often been determined by domestic political or bureaucratic considerations rather than size of potential trade benefit (for example oranges, Kansai airport construction) for the United States.

The second source of frustration is more intractable; it lies in the private, non-governmental obstacles to imports. Basically the Japanese society and economy is not outsider-friendly. "Culture" is too readily offered as an explanation without specifying what is meant. Obviously the Japanese language is a real obstacle to some business in Japan. (English is less of a barrier in that it is now the international language of commerce and diplomacy, so that the benefits of learning English are far greater.) But a number of institutional arrangements and behavioral patterns also make it more difficult to penetrate Japanese than most markets, including the distribution network; long-term
relationships between groups of suppliers and buyers; weaker anti-trust laws and implementation than in the U.S. which allow far greater exercise of market power; and a system of conflict resolution that relies upon private negotiation, mediation, and compromise rather than the legal system and courts. Market entry costs are high -- a quality product, high service, substantial investment, and a long-term strategy and commitment are requisite. The pay-off can be very profitable, as a number of American firms exporting to and producing in the Japanese market quietly attest.

It is not that Japanese consumers are xenophobic; they prefer high quality, low priced goods regardless of source. Japanese companies, however, do have a preference to obtain intermediate inputs from Japanese sources -- as much for reasons of convenience, assurance of stable supply and quality, and long-term implicit contractual relationships as for any explicit anti-foreign attitudes per se, I surmise. Preferred reliance on domestic suppliers is characteristic of all economies, but is probably carried further in Japan than elsewhere.

The relatively small size of Japan's imports compared to GNP, and of manufactured imports as a share of total imports and, more relevantly as a share of GNP or total apparent consumption of manufactures, have been argued to imply pervasive Japanese protectionism. A series of studies refutes this argument; they show that both the share and pattern are normal, reflecting Japan's paucity of natural resources and its distance from major markets. Macroeconomists argue that, given Japan's surplus of savings over investment, it inevitably will have a surplus of exports over imports. The implication is that if Japan is to import a higher percentage of manufactured goods (as it will) then exports will
also have to rise, though not as much since the size of the current
account surplus relative to GNP will decrease, and will involve less
merchandise exports as interest and profit income rises.

Trade issues in high technology industries are particularly
difficult to deal with, as the 1986 Summer U.S.-Japan semiconductor
trade agreement epitomizes. R&D is very important, technology changes
rapidly, and the process of learning-by-doing, learning-from-others,
diffusion of technology, and leapfrogging is complicated, poorly
understood, and hence difficult to evaluate. In semiconductors and
microelectronics more broadly there are direct military/national security
implications — in telecommunications, data processing, military hard­
ware, for example. Should the U.S. maintain a full-blown semiconductor
industry including substantial capacity in commodity chips for defense
reasons? If so, are the semiconductor capacities of IBM and AT&T
sufficient for emergency defense needs, or are a number of merchant
vendors of commodity chips required in addition? If so, how should the
costs be borne and how can the incentives best be provided for efficient
production and aggregate rates and kinds of R&D? Based on industrial
experience to date, import restriction is an inefficient mechanism to
implement the type of industry-specific policy some argue is needed to
maintain adequate levels and types of civilian goods production and
innovation to meet military needs. 10

The 1986 U.S.-Japan semiconductor agreement is seriously flawed:
it does not solve the problems of American semiconductor producer
productivity and competitiveness; it embodies bad economics, and it is
virtually impossible to administer (monitor and implement) effectively.
Perhaps we should not be surprised that it became bad politics as well.
The economics are bad because it sets a floor price on commodity semiconductors applicable not just in the U.S. but the world, with the price based on Japanese average rather than marginal cost of production plus a high profit rate (8% of sales); and it requires Japan somehow to increase substantially its imports of commodity chips from American producers in the United States, with target market shares strongly implied. The floor price system is a U.S.-Japan producer de facto worldwide price cartel arrangement, harmful in itself and impossible to maintain. Korean producers are lower cost and production is shifted to them; semiconductor users are hurt in the United States and helped in Japan; leakages via third countries and in other ways in essentially an unregulated, relatively unconcentrated, market-driven commodity chip market are inevitably large and very difficult to prevent. The U.S. insistence on a substantially increased market share in Japan, somehow guaranteed by the Japanese government, is difficult to implement since semiconductor users in Japan as in the United States are highly competitive firms operating in private markets. MITI does not have such enforcement power to re-quire purchases, and consonant with objectives of moving to increasingly competitive, open, market-oriented system in Japan, should not have such powers.

The actions of President Reagan on March 27, 1987 announcing imposition of prohibitive tariffs on $300 million worth of selected Japanese electronic and industrial goods in retaliation for Japan's non-enforcement of the Semiconductor Agreement -- both pricing in third markets and access to the Japanese market -- is not only symbolic of both the difficulties of dealing with high tech trade issues and the bilateral mismanagement of these issues, but has substantive meaning as
well. It became a lightning rod, one of several, for Japanese articulation of feelings of frustration and anger at the United States for "Jap-bashing" and scapegoating; in Japanese perspective the real U.S. economic problems lie at home (inability to control the budget deficit, lack of industrial competitiveness and productivity growth, poor quality control, and lack of effective export efforts).

The dilemma is that the trade negotiations in both countries have fallen into a negotiating approach and style which may (appear to) resolve specific issues satisfactorily but has the cumulative effect of substantially increasing the American perceptions of Japanese intransigence and unfairness, and Japanese perceptions of American "Jap-bashing" in which scapegoating of Japan is substituted for American efforts to solve their own problems. The gap between American and Japanese on perceptions of each other has never been so wide.

The pattern is as follows. Japan never initiates any market opening actions; it does so only in response to U.S. pressure. Moreover, Japanese officials initially resist American requests through delaying tactics and inaction; American negotiators press harder and harder, typically with an increasing sense of frustration and irritation. Only when American pressure becomes very intense, often quite politicized, do Japanese negotiators make concessions. The lesson: Japan will respond only when it is hit hard.

There are complications on each side. Japanese bureaucrats frequently seek U.S. pressure in order to resolve a difficult domestic political impasse which prevents a decision, enabling them to blame the resolution on U.S. pressure (e.g., scapegoating the U.S.). The U.S. Administration negotiators and members of Congress on occasion engage
in a "good guy-bad guy" routine to exert greater pressure on Japan. Moreover, it may well be that economically relatively modest items are deliberately placed on the agenda. A choreography proceeds in which Japanese negotiators resist, American negotiators press. Eventually Japan makes a concession, and the American negotiators can plausibly claim a symbolic victory which indicates that Japan is really changing its ways, that the Administration has the Japan relationship fully under control, and Congress need not undertake any trade restrictive or retaliatory legislation.

This negotiating procedure is a fundamentally flawed approach to management of such an important, mutually beneficial alliance relationship. While the negotiators may understand the game and its rules well (perhaps a charitable interpretation), it is not at all clear that members of Congress and the Diet do, that the media do, or that the general public does. Yet the inevitable entrance of these issues into the public domain, because of the way in which the press-resist process is played out, mean that Americans in general develop an ever-growing sense of frustration and anger over Japanese "unfairness" which is loudly articulated; and that Japanese develop an ever-growing sense of frustration and anger over American "unreasonableness" and arrogance which up to now has been voiced only in a quite muted manner, but is likely to become increasingly vociferous.

The concern of all -- Americans, Japanese, those in the Pacific Basin and elsewhere -- is that the frustration, anger, and resentment engendered by the style of negotiations will negatively affect substantive outcomes. Anger often leads to emotional appeals for retaliation. Retaliation itself is always market-restricting, though American threats of
restrictive retribution are part of the choreography in pressing Japan to open markets. The danger of decisions based on emotions and sentiment is that they typically diverge from optimal policies based on a careful rational assessment of one's own national interest.

The recent rhetoric in the United States and Japan, enflamed by the media in both countries, that we are entering a "trade war" is the wrong metaphor and a serious mistake. A trade war means sharp diminution, indeed virtual cessation, of trade and other economic relations: application of major sanctions embargoing exports and imports of goods and capital (who trades with the enemy, after all). That would strike at the core of all dimensions of the U.S.-Japan relationship, since at that level all are linked. No responsible policymaker or thoughtful citizen would seriously espouse a trade war; the harm to one's own country, much less the other and indeed the world system would be too great.

A more appropriate analogy is between two long-term business partners and close friends, each with his/her own self-interests but very strong mutually beneficial interests as well from the relationship. Over time their relationship has grown; and the junior partner has been more dynamic, taking a greater share of the ever-increasing action. As in any close relationship specific disagreements and problems emerge from time to time, important in themselves and reflective of the evolving power relationship between the two. The senior partner frets that the junior partner is too pert, aggressive and selfish, does not take greater responsibility for the relationship; the junior partner worries that the senior partner is getting soft, and somehow is unable to manage himself and the partnership as well as he did in the past. The senior partner
becomes increasingly resentful that while he shares his business with
the junior partner, the junior partner shows little willingness in turn
to share his own, now very large business, and only grudgingly gives in
to increasingly sharp protests from the senior partner as the commercial
imbalance between the two grows and grows. Yet things are basically
going so well and both are benefitting so much that neither seriously
contemplates ending the partnership; too much would be lost.

Then for domestic reasons the senior partner suddenly decides he
must spend a great deal more than his income, has to get real resources
not all from his junior partner but from all others with whom he does
business, and has to borrow to finance these resource inflows from his
partner, as well as others — in growing amounts for five years and then
in declining amounts (hopefully) for another five years or so. The now
strong junior partner is generating large cash flow and does not know how
to invest it at home, and is glad to lend it at good interest rates to
such a good market risk as well as good friend. After all they are
partners. They have now become huge partners with huge benefits, but the
commercial imbalance has become intolerable for the senior partner,
serious strains are apparent on both sides, the senior partner is piling
up more and more debts, while struggling to get his house in order.
While he recognizes that many of his problems are his own creation, he
also knows that his partner's vigorous expansion and direct competitiveness
are an important source of his difficulties as well. The partners
are at an impasse: it would be crazy to end the partnership since the
costs would be too great; but over the years they have developed a
mind-set and mechanisms for handling their problems that no longer work.
Each is unhappy; each blames the other; and each has to get his own house in order to make the partnership more manageable and beneficial.

IV. Systemic Issues: Bilateral Undermining of the Multilateral Trading System

The United States and Japan are each such large members of the international economy that the ways in which each resolves its own or bilateral issues have an impact not just on the other Pacific Basin and other economies but on the nature and rules of the international trading system itself. Thus, while systemic issues are inherently global, the United States and Japan individually, and even more so in joint bilateral actions, play a dominant leadership role, for better or worse. The effects are at both the macro and micro, or sectoral, levels.

The keystone of American foreign economic policy over the past 40 years has been the development, maintenance, and strengthening of an open, multilateral trading system under GATT based on fundamental principles of non-discrimination (most-favored-nation treatment), prohibition in principle of quantitative restrictions (quotas), elimination of tariffs, and equal national treatment of domestic and foreign-owned firms. The very success of earlier rounds of negotiations to reduce tariffs on manufactured goods, culminating in the Tokyo Round in 1977, has brought to the fore a whole host of new issues: quotas, standards, trade barriers in agriculture and services, intellectual property rights, structural adjustment and safeguards, et cetera. While GATT has many problems, it nonetheless continues to play a major institutional role in inhibiting major countries from going protectionist and
hence in maintaining the existing system; in serving as the ongoing focus to negotiate further reductions in remaining tariffs and non-tariff barriers; and in providing some mechanism, though flawed, for new negotiations on even more difficult agenda items. 11

Vis a vis Japan, the U.S. multilateral policy thrust has been largely successful: to have Japan become a full-fledged member of GATT, to commit itself in principle to a policy of free trade and open access to its markets, and to take an increasing leadership role in GATT, particularly in the negotiations to initiate the new Uruguay Round of GATT negotiations. Japan of course adopted those policies to achieve its own goals since it is one of the major beneficiaries of the international trading system. In practice, however, there have been three major problems: Japan's slowness to open remaining important specific markets (discussed in the previous section); Japan's initiative, at least certainly its willingness, to strike bilateral deals with the United States and the European Community which are outside of, contravene, and hence undermine, the GATT system; and Japan's reluctance to take on a leadership role in the maintenance and management of the international trading system.

The key systemic macro issue: can the international economic system simultaneously maintain both free trade and free financial and capital flows when major countries pursue divergent macroeconomic policies, made possible by a flexible exchange rate system, which result in huge national trade imbalances for a sustained period of time? This is being tested in the United States now; it may well be that when trade deficits become as large as they have, the U.S. is no longer willing to maintain an unfettered free and open trading system. But Japan constitutes another
test. Japan's huge trade surplus may be fine from a purely Japanese perspective, but its excessive size is unacceptable to the U.S. and other major leaders of the trading system.\textsuperscript{12} Hence the strong desire in current G-7 policy discussions to achieve a reasonable and stable target zone of exchange rates now that the extreme misalignment of dollar overvaluation and yen undervaluation have been corrected. Essentially that discussion rests on arguments for coordination of macroeconomic policies among the major players, notably the United States, Japan, and West Germany since exchange rates are the symptomatic consequence of the interplay of domestic macro policies and behavior, and especially expectations of market participants regarding changes in these variables, rather than being a major independent policy variable.

To summarize, if both the United States and Japan cannot reduce their trade imbalances through macro measures, and if they cannot pursue macroeconomic policies along parallel (if not formally coordinated) rather than divergent paths, than there is increasing likelihood the United States will abandon its free trade policy for one of some form of protectionism (probably managed trade of major manufacturing sectors, as is discussed below). That would substantially alter the international trading system as we know it -- to the disadvantage of the United States, Japan, and the whole world, since the benefits to specific anti-trade interest groups would nowhere meet the costs borne by the general public.

At the same time, the micro foundations of the international trading system have been under increasing threat as an unintended consequence of the ways in which the United States and Japan handle their specific
sectoral and product frictions with each other. There have been two countervailing forces.

On the one hand, in support of the system Japan has substantially reduced its trade barriers, particularly in manufactured goods (its source of competitive advantage). Much of this has been due in significant part to ongoing American pressure on Japan to open its markets. Much also simply reflects changes in Japan's economic power and competitiveness; not only was it viewed as "inevitable" that Japan reduce its import barriers, it became increasingly evident it was in its own narrow interest to do so, as well as in its interest in supporting the international system. After all, that is what countries are supposed to do under the implicit dynamic rules of the GATT game. ("Graduation" which Japan achieved in 1964, is one step in what should be perceived as an ongoing process.) Indeed the foreign complaint is that Japan has moved much too slowly, and has required far too much foreign pressure, in the pace and kind of liberalization it should undertake as a GATT member and world leader. In this perspective comparison of the degree of Japan's protection vis a vis the United States or the European Community is irrelevant. Leadership requires that countries, particularly Japan, in a good economic position -- steady growth, low inflation, low unemployment rates, current account surpluses -- should continuously reduce remaining trade barriers in order to maintain and strengthen the GATT system. Japan lost a great opportunity to open its markets greatly between 1982-1985 when its exports were growing rapidly and adjustment would have been less difficult; now it faces liberalization in an adverse domestic and external environment. The major systemic problem comes from the way in which Japan and the United States have resolved trade problems
affecting specific American industries where import penetration by Japanese firms have hurt American producers. The United States has sought to solve difficulties of domestic structural adjustment by taking some form of ad hoc specific import-restrictive measures as exceptions to the general rule of open, competitive markets. Typically, these measures have been initially negotiated with Japan in a series of bilateral deals, entirely outside the GATT system. In the process new policy instruments have been developed and applied to an ever-increasing range of products; and the U.S. import restrictions have been applied to an ever-increasing number of countries from which the United States imports.

The cumulative effects of these specific deals is huge. Some 43% of U.S. imports are now covered by special non-tariff barriers, most of them imposed in the past decade and most as a direct consequence of bilateral arrangements with Japan. The size of such bilateral deals means they no longer can be considered a minor exception; they constitute a major challenge to the GATT multilateral system in its very area of strength, namely manufactures. Indeed, it appears the United States, Japan, and the world are well on the way to a system of managed (some would say centralized) trade rather than free trade in major sectors.

The most fully developed manifestation of this pattern is the Multi-Fiber Agreement (MFA) for textiles, under which developed countries impose commodity and counter specific quotas on the full range of natural and synthetic yarns, cloth, and garments from developing countries. This multi-country multi-product monstrosity evolved in a series of broadening actions out of a simple U.S.-Japan bilateral
voluntary export restraint agreement in 1957 to limit U.S. imports of Japanese "dollar blouses" and imprinted cotton cloth. Steel, automobiles, and (temporarily at least) semiconductors are now well along the path to managed trade.

A number of new import-restrictive policy instruments have been devised, or old ones resurrected, by the United States and Japan working together to solve specific sector problems. Color television imports from Japan came under an orderly marketing agreement (OMA) in the late 1970s. The trigger price mechanism (TPM) set a floor price on steel imports from all countries between 1977-1981; that mechanism acknowledged Japanese steel companies were on average, the world's lowest-cost producers, and used their constructed average (rather than marginal) costs of production to set the floor price. MITI and the Japanese steel industry cooperated with the Department of Commerce to obtain industrywide average cost estimates. When the dollar exchange rate rose from 1981 so that steel import floor prices dropped, the U.S. industry forced the termination of the TPM and were successful in having the U.S. Government impose import quotas (negotiated bilateral voluntary export restraints) in their place. The constructed average cost procedure (with a high profit margin) to set floor prices, based on the anti-dumping provisions of the 1974 Trade Act, is generally regarded as a violation of GATT rules; most U.S. exports would not meet the import pricing test. Nonetheless, it has been applied in the 1986 U.S.-Japan semiconductor agreement to Japanese exports of semiconductors not just to the United States but to the entire world. This agreement has aspects of an implicit cartel, seemingly presuming that American producers will have
relatively preferential position in the U.S. market, Japanese producers in the Japanese market (though the U.S. market access provision runs counter), and European producers in the European market.

Perhaps the most important new trade-restrictive instrument to develop out of U.S.-Japan bilateral negotiations is the voluntary export restraint (VER). Rather than the U.S. imposing import restrictions, it prevails upon Japan "voluntarily" to restrict exports of particular products to the U.S., typically by having MITI allocate quotas to Japanese producers. I suspect this instrument was invented by Japanese officials. It certainly appeals to their preference for ad hoc case-by-case, pragmatic compromises rather than application of universal systemic principles; moreover, it enhances the now-waning powers of MITI bureaucrats. A VER has the advantage of fairly frequent (annual) review; it is flexible; and it can be readily removed when conditions no longer warrant its continuation. The VER system is likely to be most effective in concentrated industries of relatively few producers, both for quota allocations and to monitor and prevent possible cheating. Like other quota systems, the VER is less efficient in resource allocation and degree of welfare loss than tariffs or subsidies -- but it has its presumed real-world political-administrative advantages of feasibility. Moreover, it (like other quota systems) means that the extraordinary profits (rents in economic terminology) on imports resulting from higher prices consumers pay may well be captured by the export producer rather than by the importing country, in contrast to a tariff. This makes the VER economically and politically attractive to the exporting country. Its alleged voluntary feature makes it attractive to the importing country with systemic responsibilities.
The first VER in postwar U.S.-Japan trade was on a few cotton textile items from 1957, as already noted. The major VER in U.S.-Japan trade has been on U.S. automobile imports from Japan since 1981. American consumers in effect did much to keep a number of possibly marginal Japanese automobile producers in business; their high profits in the U.S. market offset losses in Japan since 1984, perhaps earlier, only one Japanese producer has apparently made money in the Japanese market). Yen appreciation has eliminated these extraordinary profits in the U.S. market for Japanese car producers, and they have had to raise prices somewhat to prevent losses. The VER is more than a modest exception to free trade; in 1986 U.S. imports of automobiles, trucks, and automotive parts from Japan amounted to $32.8 billion (c.i.f.), 40.1% of U.S. total imports from Japan (cars alone were $21.1 billion).

Bilateral trade restrictive deals with Japan or other major partners almost always reflect an American attempt to help certain politically-powerful industries facing severe import competition while not abandoning the rhetoric of free trade principles. However, import restriction is probably a less efficient mechanism for domestic structural adjustment than a package of other policies (labor retraining, subsidies, low interest rate loans, performance criteria, etc.), assuming the government must do something. One problem with bilateral deals is that they encourage shifting of production to other countries, which then replace Japan's exports in the U.S. market. To be effective, the bilateral arrangement over time has to be extended to other major countries producing the particular product, and to its close substitutes. This is the road to product-specific managed trade -- with the definition of the product ever widening.
Ultimately the success of the international economic system depends on its ability to integrate Japan into the system as a major player and fully established member. This will require changes in behavior and perceptions in the United States and Japan, and Western Europe as well. Japan is reluctant to assume a role of economic leadership but that will be increasingly forced upon Japan if it does not want the trading system to fall apart and its economic relations with the U.S. to deteriorate further.

What are the systemic responsibilities of economic leadership? First and foremost is to open one's domestic markets to inflows of goods, services, and capital: to remove remaining barriers, and to eschew the new imposition of import restrictions to solve structural adjustment problems as they inevitably arise in specific products and sectors. The reality, and especially the foreign perception, must become that Japan is truly an open economy. Second, an economic leader must support very substantially the economic development process of the Third World — by importing, by providing foreign aid, by technology transfer, by capital flows. Third, an economic leader must contribute to the world pool of basic scientific and technological knowledge through its own basic R&D efforts. Fourth, an economic leader must make it possible, and indeed attractive, for its currency to be used for international trade transactions, to denominate capital flows, and as a central bank reserve currency. By all these criteria Japan has made substantial progress over the past decade — and still has a long way to go.

The United States and Japan together pursue contradictory policies. They endorse and support GATT; and they systematically and
increasingly strike specific-sector deals on access to the U.S. market. The present GATT round provides an opportunity to place greater emphasis on the multilateral approach for resolution of such problems. Nonetheless there is the real danger that bilateral deals will continue to be the approach used in the future to solve particular problems in manufactured goods trade, that the arrangements will be generalized, and that a greater proportion of trade in manufactures will come under MFA-like arrangements. If so, much of that process will continue to emerge from the way in which the U.S. and Japan deal with each other. If this occurs, the international trading system will evolve into something quite different, and more restrictive, than the vision of the founders of the postwar international trading system. The great systemic challenge for U.S. and Japanese trade policy alike over the next 5-10 years of Uruguay Round negotiations is to strengthen and expand the multilateral system of open, non-discriminatory trade while dealing positively with the very real problems of structural adjustment that are an inevitable element in the process of economic growth, technological change, and expansion of trade.

V. Implications for the Pacific Basin Economies

The implications for the other Pacific Basin economies as to how the United States and Japan manage their bilateral trade relationship are profound and obvious. The United States and Japan are by far the world's as well as the region's largest economies, the major trading partners for the other Pacific Basin economies, and both the maintainers and underminers of the GATT-based international trading system.
Moreover, virtually all the Pacific Basin economies are pursuing an export-oriented development strategy — the NICs and Malaysia to a great degree, the others, even China and perhaps Australia, more modestly but nonetheless significantly. For better or worse — and there is much of both — the trading practices and policies of the United States and Japan, individually and jointly, have major impacts on Pacific Basin economic growth, trade policies, and development strategies.

As the success of the Asian NICs well demonstrates, the Pacific Basin economies benefit immensely from participation in the still quite open multilateral trading system in manufactures. These benefits are linked directly to good, sustained economic growth by the United States and Japan, to the maintenance (in the U.S.) and expansion (in Japan) of open markets, and to further liberalization and strengthening of the GATT-based multilateral trading system and its rules.

Analytically, the positive and negative spill-over effects of the U.S.-Japan trading relationship can be placed in the macro, micro, and systemic perspectives provided above, even though in practice these issues are closely intertwined. The key issues for the Pacific Basin economies are how the U.S. and Japan will reduce their respective global trade imbalances; what the yen-dollar exchange rate will be; whether the U.S. will take protectionist measures which seriously restrict access to all or important segments of the American market; whether Japan will continue its market opening process, particularly in land-based and labor intensive sectors, without retreating from existing levels of openness; the effect of U.S.-Japan specific product bilateral deals in the short-run and the longer run; whether the U.S. and Japanese bilateral preoccupation on each other means each is less responsive to the broader
interests and concerns of the Pacific Basin region to their detriment, or on net balance has positive spill-over effects; and whether the U.S. and Japan will succeed in strengthening the GATT multilateral system, or continue the process toward managed trade in major sectors.

The greatest long-run benefit of the U.S.-Japan trade relationship to the Pacific Basin economies, still yet to be fully realized, has been its contribution to the gradual but steady and now quite substantial opening of the Japanese market, due in considerable part to U.S. pressure. Less noticed, but politically of equal importance, is that U.S. pressure has created a policy environment which for more than a decade now precludes Japan from exercising the policy option of raising now-lowered import barriers in industries facing temporary difficulty or structural adjustment.\(^7\) Japan can no longer utilize the anti-recession cartels of the 1950s and 1960s, which operated behind existing high import barriers, to cope with sectoral problems. The very rapid decline in less than ten years in Japanese aluminum smelting capacity -- by 90%, from 20% to less than 2% of world capacity, from 16 smelters to one (owned by Alcan and based on captive cheap hydroelectric power) -- is the most extreme illustration.

There are, however, two problems. First, as already stressed, Japan has significant specific import barriers remaining. Many are of particular interest to Pacific Basin economies but not the U.S. so they have not been on the bilateral agenda until recently, when the U.S. became concerned about the disparity between high American and low Japanese absorption of Pacific Basin labor-intensive manufactures. On occasion, the U.S. has negotiated specific market liberalizations which
benefit American producers to the detriment of other Pacific Basin economies; American negotiator success in expanding Japan's import quota solely of high quality beef, rather than all beef as a broad product category, has not been beneficial to Australian beef producers, for instance.

Second, now that the Japanese economy is entering its own painful phase of structural adjustment and slowed growth in the near term as a consequence of yen appreciation and domestic policies, will it deviate from its general policy of not imposing new import restrictions in particularly troubled sectors? Following the sharp rise in imports of textiles in 1986, it appears that Japan is currently negotiating VERs with South Korea and Taiwan. This will be a dangerous step backwards, in itself and as a possible precedent for future Japanese actions. This is not an area in which Japan "should learn from the West" except that negative lesson that this is not the appropriate trade policy path. Future Japanese future import policies in textiles, steel, and even automobiles will no doubt be monitored carefully. With the large yen appreciation vis a vis the dollar, many segments of Japan's manufactures sector are no longer price-competitive with imports. In the absence of new restrictions, Japan's imports of manufacture can be expected to continue to rise substantially, in absolute amounts and as a share of GNP and domestic consumption of manufactures.

The Pacific Basin economies have greatly and particularly benefitted from the remarkable growth in U.S. imports in the 1980s. U.S. import demand has been the main locomotive pulling these export-oriented economies forward. Inevitably they will lose this important external
stimulus to a significant extent as the U.S. over time reduces its global trade deficit. How much depends on three factors: the degree to which the U.S. substitutes Pacific Basin imports for those from Japan or other parts of the world; the degree to which increases in Japanese imports from the Pacific Basin economies offset their reduction in exports to the U.S.; and the degree to which increases in U.S. manufacturing production is for import-substitution rather than exports.

The process by which the United States attempts to reduce its global trade deficit will be significant. What some members of Congress may see as a range of policy options are in macro terms spurious: major import restrictions (protectionism); substantially increased access to foreign markets (retaliation threats); increasing U.S. competitiveness; or further dollar devaluation. At best they contribute by making import-substituting or export production more attractive. Fundamentally the U.S. has to reduce domestic demand while increasing domestic production, through a combination of reduction in the Federal budget deficit and a substitution of U.S. for foreign manufactures at home and abroad.

The various combinations of policies the U.S. pursues will have differential impacts on the Pacific Basin economies. Large-scale broad-based, or even relatively focussed, protectionist legislation will hit Pacific Basin economies disproportionately since they are the major source of textile and other labor intensive manufactures imports. The great fear among the Pacific Basin economies is that the U.S. will substantially and pervasively close its markets. That would hurt in every way possible macro, micro, and systemic. It would force either a rethinking of export-led development strategies, or the forging of far closer ties with Japan in informal or formal regional bloc arrangements.
On the other hand, further dollar depreciation will benefit the Pacific Basin economies since their currencies are tied to the dollar. Their exports to the U.S. would not be hurt and would even increase in substitution for Japanese exports to the U.S., and exports to Japan would rise as the yen appreciated. Indeed this process is already well underway. To the extent that the Pacific Basin economies increase their imports commensurate with export increases, they, the U.S. and the world are better off. By and large this is what happens. The major exception is Taiwan which has been running major excessive current account surpluses; it will be under increasing pressure both to appreciate its exchange rate and to liberalize imports. South Korea too since 1986 is now running a current account surplus for the first time. Since the nation's foreign debt is large, a moderate current account surplus combined with import liberalization is appropriate. The problem for the U.S. is that the dollar must decline on a trade-weighted basis not simply vis a vis the yen. To the extent that production shifts from Japan to Pacific Basin economies tied to the dollar, then the beneficial relative price effect on the U.S. trade deficit will not occur.

The most clear-cut spillover effects on the Pacific Basin economies lie special U.S.-Japan bilateral deals restricting Japanese producer access to the U.S. market. In the short run other Pacific Basin economies benefit to the degree to which they have, or can develop, competitive production capacity in the restricted products. In the longer run, however, their very success generates U.S. reaction: an extension of the specific bilateral import restrictions to them as well. The most outstanding case is, of course, textiles; the MFA restrains the textile exports of all the Pacific Basin economies to the U.S. and to the
European Community as well. The orderly marketing agreement on color television soon had to be expanded to South Korea, Taiwan, and Hong Kong. U.S. steel restrictions were from the beginning more broadly based, focussing as much on European dumping as Japanese cost efficiency. The most recent import restrictions have set VERs for South Korea and Taiwan as well as Japan. The 1980s U.S.-Japan bilateral restrictive arrangements in automobiles and semiconductors have accelerated production in and exports from Korea, thus far without retaliation. The more technologically sophisticated and larger the minimum efficient production scale, the slower will be the process of substitution to other Pacific Basin economies.

In the longer run, the Pacific Basin economies have to confront the two alternative models Japan and the United States pose: the GATT-based multilateral system; or managed trade in major sectors through the expansion of bilaterally-based specific sector import restrictions to all the Pacific Basin economies and indeed to the world. In the systemic context, this is what the Uruguay Round is all about. If the Round fails, then a broad retreat into sectoral, or possibly regional, protectionism is highly likely. The Pacific Basin economies, in their urging of and support for the Uruguay Round have already indicated their preference for an open, multilateral, non-discriminatory system. Given the political realities of the time, and the lack of leadership in Japan or the United States to implement a true free trade vision in practice as well as rhetoric, then the likely outcome is for modest success in the Uruguay Round, continuing inability to resolve structural adjustment problems very constructively, and a continuation of the creep toward sectoral protectionism.
### Table 1

United States and Japan, Balance of Payments Surplus or Deficit and Government Budget Deficit, 1970-1986

(amounts in billion dollars)

<table>
<thead>
<tr>
<th></th>
<th>Global Current Account</th>
<th>U.S. Current Account Deficit with Japan</th>
<th>Central Government Budget Deficit % of GNP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Japan</td>
<td>U.S.</td>
<td>Japan</td>
</tr>
<tr>
<td>Amount</td>
<td>% GNP</td>
<td>Amount</td>
<td>% of GNP Current Account Surplus</td>
</tr>
<tr>
<td>1970</td>
<td>1.97</td>
<td>2.331</td>
<td>0.2</td>
</tr>
<tr>
<td>1971</td>
<td>5.797</td>
<td>-1.433</td>
<td>-0.0</td>
</tr>
<tr>
<td>1972</td>
<td>6.624</td>
<td>-5.795</td>
<td>-0.5</td>
</tr>
<tr>
<td>1973</td>
<td>-0.136</td>
<td>7.140</td>
<td>0.5</td>
</tr>
<tr>
<td>1974</td>
<td>-4.693</td>
<td>1.962</td>
<td>0.1</td>
</tr>
<tr>
<td>1975</td>
<td>-0.682</td>
<td>18.116</td>
<td>1.1</td>
</tr>
<tr>
<td>1976</td>
<td>3.68</td>
<td>4.207</td>
<td>0.2</td>
</tr>
<tr>
<td>1977</td>
<td>10.928</td>
<td>-14.511</td>
<td>-0.7</td>
</tr>
<tr>
<td>1978</td>
<td>16.534</td>
<td>-15.427</td>
<td>-0.7</td>
</tr>
<tr>
<td>1979</td>
<td>-8.693</td>
<td>-0.8</td>
<td>-0.991</td>
</tr>
<tr>
<td>1980</td>
<td>-10.746</td>
<td>1.873</td>
<td>0.1</td>
</tr>
<tr>
<td>1981</td>
<td>4.770</td>
<td>6.339</td>
<td>0.2</td>
</tr>
<tr>
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<td>-8.051</td>
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<tr>
<td>1983</td>
<td>20.799</td>
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<td>-1.4</td>
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<tr>
<td>1984</td>
<td>35.00</td>
<td>2.7</td>
<td>-107.358</td>
</tr>
<tr>
<td>1985</td>
<td>49.169</td>
<td>3.7</td>
<td>-117.7</td>
</tr>
<tr>
<td>1986</td>
<td>86.970</td>
<td>4.2</td>
<td>-140.6</td>
</tr>
</tbody>
</table>

Notes: * in column 6 indicates opposite relationship  
- indicates current account deficit  
Japan-U.S. bilateral current account based on American data; Japan's surplus is equivalent to America's deficit.

<table>
<thead>
<tr>
<th>Table 2</th>
<th>Major Industry Specific Trade Issues Between U.S. and Japan in 1985 and 1986</th>
</tr>
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<tbody>
<tr>
<td>Industrues</td>
<td>Issues and Agreements</td>
</tr>
</tbody>
</table>

(A) Market Access to Japan

| (1) MOSS 4 sectors telecommunications medical equipment and pharmaceuticals forest products electronics (Semiconductors) | Agreement reached for 4 sectors January 1986 Liberalization of telecommunications terminal equipment and network service Revising regulatory system to increase transparanry of examination Removing tariff and non-tariff barriers Liberalization of computer parts, including patent process Improving market access, monitoring cost and price of Japan's products in U.S. and third country markets; agreement signed September 1, 1986 |
| (2) New MOSS transport equipment | Agreed in July 1986 and started discussions from August 1, 1986 |
| (3) Leather and leather shoes | Removed quotas, changed to tariff quota from 1986 |
| (4) Wine and alcoholic beverage | Reducing tariff on wine, revising law to ad valorem tax |
| (5) Cigarettes | Government monopoly on production, high tariff plus law limiting market access: agreed to reduce tariff in 1987 to zero. |
| (6) 12 agriculture products under quotas | Request for GATT panel based on Article 23 |

(B) U.S. restrictions on imports from Japan

| (1) Iron and Steel | Limiting Japan's share in the U.S. market to 5.3% of consumption, agreed in May 1985 starting October 1984 for five years |
| (2) Automobiles | Continuing voluntary export restraint which limits Japan's annual exports to 2.3 million units for 1986 fiscal year, agreed in February 1986 |

Endnotes

1. I follow conventional classifications in defining the Pacific Basin region as comprising three categories of economies: the advanced industrial economies of the United States, Japan, Canada, Australia, and New Zealand; the eight or so major Asian developing market economies (ADMEs) of South Korea, Taiwan, Hong Kong, and Singapore (the Asian NICs), and Indonesia, Thailand, Malaysia, and the Philippines, plus Brunei (the resource-rich ASEAN members other than Singapore); and China (an increasingly open, socialist economy). This discussion abstracts from the U.S.-Canada trade relationship, focussing on the economies of the Western Pacific. See also Hugh Patrick, "The Burgeoning American Economic Stake in the Pacific Basin", in James W. Morley, ed., The Pacific Basin -- New Challenges for the United States (New York: The Academy of Political Science, 1986).

2. The companion piece by Lawrence Krause, "Financial Issues between Japan and the United States," nicely addresses these issues in a macro, systemic framework.


4. The share of manufactures in Japan's total imports rose sharply from 30.5% in September 1985 to 47.7% in October 1986; while part was due to a decline in the price of oil, nonetheless the share of manufactures in non-oil imports rose some 12.5 percentage points. Much was textiles and other labor-intensive goods imported from Japan's Pacific Basin neighbors. More generally in 1986 Japan's export volume declined 1.2% and import volume increased by 12.9%. In value terms Japan's current account surplus increased by $38 billion, and Y27 trillion; in yen values exports decreased by 16.6% and imports by 32.0%, due particularly to the sharp drop in oil prices. It might be noted that between 1981-86 U.S.exports to Japan increased by 23%, but to the world as a whole decreased by 10%.

5. The respective U.S. and Japanese trade change flows are heuristic guestimates rather than based on substantial and careful analysis; they are given here to indicate orders of magnitude. Note that the reductions in current account imbalances will be less than trade imbalances since the U.S. will be increasing its interest and dividend payments and Japan its receipts. The longer-run implications of trade patterns and imbalances as a result of the respective changes in net debtor and creditor positions is not addressed here in any detail; see the general statement on page 5.
6. A few American industries would benefit, where their price-elasticity and capacity to supply is greater than non-Japanese foreign producers. Certain automobile lines are quantitatively the most important potential case; however past experience suggests U.S. firms are likely to raise prices more than output and obtain windfall profits. This is an inequitable and inefficient way to increase savings in the United States (to the degree the profits are saved, directly or indirectly), and the macro savings and employment effects would probably be small. More important in car trade within two years will be the huge increase in Japanese cars produced in the United States and Canada.

7. The overvaluation estimate is from Krause, *op cit*; it is the February 1985 peak relative to the 1980 value. There are at least three reasons why the dollar will have to decline below its earlier competitive equilibrium rate to achieve at current account equilibrium (at, say, 1980 levels): the huge interest payments deficit will have to be covered by greater increase in exports, as already noted; once foreign firms have invested in and established market shares and distribution networks in the U.S. they will be more difficult to dislodge (hysteresis argument); and the U.S. will have to overcome the increases in cost competitive industrial capacity in the rest of the world (particularly in the Pacific Basin and other NICs).

8. The 1987 (post-Tokyo Round) average tariffs on a trade-weighted basis (using 1976 trade for the weights as were used in the Tokyo Round negotiations) are 6.2% for Japan and 3.3% for the U.S. However, Japanese tariffs are high on agricultural and foreign products; on industrial products the average Japanese tariff is 2.3%, the U.S. 4.3%. Quotas and other official non-tariff barriers are applied to 12% of Japan's trade, 43% of U.S. trade (remember textiles, automobiles, steel); however, these UNCTAD-based measures are crude. Gary R. Saxonhouse and Robert M. Stern, "An Analytical Survey of Formal and Informal Barriers to International Trade and Investment in the United States, Canada, and Japan", presented to Conference on U.S.-Canadian Trade and Investment Relations with Japan, Ann Arbor, Michigan, April 2-3, 1987, Tables 2 and 3 and footnote 4.

9. Saxonhouse and Stern, *ibid*, evaluates studies by Balassa, Bergsten and Cline, Leamer, Noland, Saxonhouse, and Staiger et al. These studies ask whether Japan is distinctively more protectionist than other countries; the norm is the average level of protection, not free trade (which no country attains in practice). Only Balassa's study indicates Japan is an outlier among the industrial nations; however his transportation cost measure is seriously flawed, and the results are skewed by the fact that the European nations trade so much with each other.
10. National security increases offset U.S.-Japanese trade in other strategic sectors as well, notably agriculture and energy. Japan has used increasingly a national security argument to justify inefficient domestic agricultural production once the United States indicated it is a highly but not absolutely reliable supplier; stockpiling and geographic diversification of sources make more sense, however. The U.S. prohibits the export of oil, which is of bilateral significance given the location of Alaskan oil which ends up being shipped to the Eastern part of the United States.

11. I do not attempt here to review GATT and its problems or the current (Uruguay) Round of negotiations just underway, in any detail. Accordingly, many issues important to the Pacific Basin, such as the generalized system of preferences or conditionality, are not treated since they are not central to the U.S.-Japan relationship.

12. Ironically, if the United States had maintained a current account balance of essentially zero in the 1980s, as it averaged in the 1970s, Japan would have had a smaller but still substantial current surplus of perhaps $25-$30 billion -- and would probably be praised for lending its savings, directly or indirectly, to the Third World.

13. Such quantitative estimates have to be treated with caution, since typically they are weighted by actual trade amounts rather than simply a listing of the number of items. Thus a very restrictive system would prohibit imports entirely and would not enter the estimates, while a system of only modest restriction would allow substantial imports (e.g., automobiles) and raise the estimate of restriction.

14. These quotas do not yet apply to textile trade among the developed countries, though current U.S. legislative proposals do contain such provisions. Japan is the only advanced industrial country not to apply the MFA quotas; however, its textile imports increased rapidly in 1986 and it is apparently negotiating voluntary export restraints (VERs) with South Korea and Taiwan.

15. The U.S. action on April 18, 1987 of applying focussed prohibitive tariffs to imports of selected items produced by Japanese companies which also produce semiconductors as retaliation for alleged non-conformity to the 1986 semiconductor agreement may become an important variant in retaliation instruments, in at least two respects: it was applied without presentation of evidence of Japanese non-compliance and of estimation of trade affected; and it was evidently targetted specifically at major Japanese semiconductor producers even though its impact is on a wider range of companies such as Matsushita, Sharp, Epsom, and in power tools Makita and Ryobi as well as Hitachi. New York Times, April 18, 1987, p. 31.
16. This crucially depends on the political and administrative capacity of the U.S. Government to develop and implement efficient industry-specific programs based on market-conforming competitiveness criteria for structural adjustment. This, however, is an open question. See Hugh Patrick, "Reflections on U.S. Industrial Policy for Troubled Industries, in Light of Japanese Experience" (draft, April 1987).

17. The only exception of which I am aware has been Japan's imposition of import quotas (VERs?) on raw silk and silk thread from South Korea, China, and Thailand -- a quantitatively small trade item.