Section 301 and the United States-Japan Economic Relationship: Reflections on Kuroda

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Makoto Kuroda, former MITI Vice-Minister for International Economic Relations, has something of a reputation for being unusually frank and at times combative. I appreciate the stimulating and provocative views he presents in his paper; they force us to listen and to think, if not always to agree. Although he speaks only for himself, I consider his comments to be reflective of much current Japanese thinking; his paper provides a nice lightning rod in framing the issues I consider here. We need to hear and understand much better the full range of Japanese views. While silence may be golden to the Japanese, as Kuroda intimates, the lack of Japanese explanations of their behavior, goals and views, is doing Japan a real disservice at a time when the policies of the United States and other nations are fueled by ignorance and misperceptions about Japan. This is not to say that knowledge will make these problems go away; the problems are substantive and real. Yet knowledge is essential if the United States is going to make good policy decisions rather than bad.

My purposes here are first, to comment on some of the specific issues raised by Kuroda, and, second, to expand on them by making several more general comments on the political economy of the U.S.-Japan economic relationship. I argue that while Kuroda makes a number of valid and important points, he is (perhaps self-servingly) optimistic, and ignores the broader political economy realities of the bilateral relationship which have shaped the passage and implementation of Super-301.

Super-301 and Japan

The gist of Kuroda's argument is that Super-301 and related American unilateral trade policies are costly, ineffective, and unnecessary. They are costly because: they divert attention to and indeed undermine the Uruguay Round of the GATT multilateral negotiations in this crucial final phase; they result in strong negative, at times emotional reactions in Japan and elsewhere so as to diminish prospects for cooperation; and they invite retaliation as other countries engage in similar policies. They are ineffective because: even if successful, they will only marginally reduce the U.S. global and bilateral trade deficits; Japan and other countries will refuse to negotiate under the Super-301 rubric; the European Community and Japan, and perhaps others, will probably counter-retaliate against any U.S. retaliatory actions. They are unnecessary because U.S. and Japanese macroeconomic and exchange rate policies are working to reduce their respective trade imbalances, and to generate rapid increases in U.S. exports to
the world and especially to Japan.

Kuroda implicitly dismisses as a dangerously short-run domestic political sell-out the U.S. government position that Super-301 will indeed open foreign markets and that the U.S. had to take such unilateral actions to protect itself since the other major industrial nations had delayed in starting the Uruguay Round negotiations. Indeed, Kuroda's paper combines a sanguine optimism about the future course of U.S.-Japan economic relations and implicit threats that Japan will in the future take issues to the GATT or even counter-retali ate against any future U.S. 301 retaliatory actions. He provocatively asks what could Congress really do, rhetoric aside, that could be worse punishment than designating Japan as an unfair trading partner, as many Japanese interpret the May 1989 citing of Japan as a priority country for negotiations under Super-301.

Many American economists share a number of Mr. Kuroda's economic policy views. First, Super-301 is not a good instrument of policy: its unilateralism and potential use of retaliation by restricting imports go against the basic tenets of the GATT-based, open, multilateral trading system the United States has worked so hard to craft; and it gravely offends and invokes anger, resentment, and possible retaliation from America's trading partners. It substitutes U.S. power for mutually agreed-upon rules; that is neither a desirable nor a sustainable system. Second, the U.S. global trade deficit, and Japanese global surplus, are essentially separable though related macroeconomic phenomena to be resolved by macroeconomic policies. In essence, the U.S. spends more than it produces, invests more than it saves, and has to borrow from foreigners to cover the difference; and Japan saves and produces more than it invests and spends at home. Super-301 and other trade policies to open foreign markets or to restrict imports will make only a minor contribution to the reduction of the U.S. trade deficit. This basic truth has been well enunciated by Carla Hills, the United States Special Trade Representative, and other Administration officials. Third, focus on the U.S. bilateral deficit with Japan, large though it is, does not make economic sense in the context of a multilateral trade and payments system; it is most efficient to buy from the cheapest sources and to sell in the most profitable markets. It is global, not bilateral, balance that should be the objective of policy.

However, policy is not legislated and made in a vacuum. One of the important atmospherics in the debate leading to the 1988 Omnibus Trade and Competitiveness Act was that many congressmen intended Japan to be a major target. This is evidenced in the many
legislative proposals that were directed specifically at Japan, as is discussed elsewhere in this book. Perhaps that is not so surprising.

After all, Japan had emerged in the 1980's as the most important economic and technological challenge (some would say threat) to the United States. Japan is by far the world's second largest economy, $500 billion bigger than numbers three and four (West Germany and France) combined. Japan, with the United States, is at the frontiers of a far wider range of civilian goods technologies than any of the Western European countries. It has demonstrated immense competitive strength in a number of industries important to the United States - including automobiles, steel, consumer electronics, office equipment, semiconductors. Japanese products, many of them brand name, are highly visible in the American market. Japan not only has developed an increasingly large global current account surplus but also a huge bilateral trade surplus with the United States, up to two-fifths of the burgeoning U.S. global trade deficit. And Japan suddenly emerged as the world's largest creditor, and main financier of America, at a time when the United States was rapidly becoming the world's largest debtor. Importantly, Japan has not been well known, much less understood; and Japanese behavior, practices, institutions, business and negotiating styles, and basic values have seemed even more different from the United States than they are in reality. Moreover, despite the clear evidence of declining and low Japanese tariff and quota barriers on most goods, the perception has become increasingly widespread that the Japanese market is somehow closed, and unfairly so.

Moreover, the way Japan had chosen to manage trade its issues with the United States over the previous decade must have contributed to the congressional perception that the Super-301 provisions would be a useful instrument for dealing with Japan. What lesson had congress learned from the series of bilateral trade negotiations between American and Japanese officials from the 1970's on? First, the Japanese negotiators were not forthcoming; indeed, they were resistant to U.S. proposals (which always involved liberalizing changes in Japanese policy, without concomitant U.S. concessions). Only after the American negotiators pressed with increasing vigor and with threats of retaliation of one kind or another, in what was a lengthy and frustrating process, would Japanese negotiators make substantial concessions. Moreover, they never seriously threatened counter-retaliation, and in the one case (semiconductors) where the United States did impose retaliatory tariffs on selected imports from Japan, Japan neither retaliated nor took the issue to the GATT. The lesson: set time limits in negotiating with
Japan; be prepared to retaliate and have in place mechanisms to do so. The payoff: Japan would make concessions to open its markets and would not retaliate.

Apparently the Administration in spring 1989 felt it had no choice: it had to designate Japan as one of the priority nations with which to initiate negotiations under the Super-301 provisions. Otherwise it would lose credibility with Congress and face the prospect of aggressive congressional legislation aimed specifically at Japan. In practice the USTR adopted a narrow interpretation of Super-301. It cited Japan for government procurement practices in satellites and supercomputers and for certain restrictions retarding wood products imports, three sectors which merited consideration in any event; and U.S. government officials were careful not to label Japan as an "unfair trading nation" despite that apparent intent in the 1988 Act.

Symbolically, however, this action was perceived in Japan as a major, qualitatively new and different, attack by the United States. The Japanese press and general public not surprisingly deemed that its major ally now regarded Japan as an "unfair trading nation". Kuroda may be exaggerating only slightly when he says, "Japan has been named as if it were an enemy of the United States." Such resentment and recriminations have been expressed openly and vocally, by the Japanese government and by the public. It has exacerbated Japanese perceptions that America "unfairly" scapegoats Japan, as an excuse instead of solving what are essentially its own domestic problems. The U.S. Super-301 action against Japan at the least increased substantially the already high tensions in the U.S.-Japan relationship; it remains to be seen whether it has added a new and difficult dimension.

Of course, in pragmatic negotiating style, while the Japanese government refused to negotiate under the Super-301 rubric it agreed to consider these three sectors under existing bilateral negotiating arrangements. And Japan agreed to the Structural Impediments Initiatives (SII) talks outside Super-301 to consider long-run structural and institutional barriers to economic openness in Japan (and U.S. barriers to its own more successful economic performance, such as the federal budget deficit, U.S. private savings rates, corporate competitiveness, and the like).

**Japan's Trade Surplus**

There are several important points to be made about the sudden emergence of Japan's huge trade and current account surpluses in the 1980's. First, Japan's industrial structure and
export performance between 1973-1985 dramatically changed as a consequence of the first and second oil crises, and the low exchange rate of the yen for most of the period. To simplify, in macro terms the Japanese economy geared up to generate enough exports to pay for needed imports predicated upon a high price of oil. Second, in fact the terms of trade have moved sharply in Japan's favor since 1980, and particularly since 1985 when the yen appreciated and oil prices in dollars dropped sharply. Kuroda's assertion that Japan's surplus since 1980 is overwhelmingly attributable to the sharp decrease in the yen price of oil and other minerals is only a moderate exaggeration. Third, sharp yen appreciation between 1985 - 1987 is bringing changes to Japan's economic structure that are still under way. Japan's current account surplus has declined from its peak, though more so in yen and real terms and as a percentage of GNP than in dollars due to the exchange rate measurement effects. The current account surplus peaked at $87 billion in 1987 and was about $57 billion in 1989; however, it is not at all clear that this measure will decrease much further in the early 1990's.

Much depends on the currency and base year chosen for comparison. For example, even though the yen appreciated 47 percent on a nominal trade weighted basis between 1985 and 1988, Japan's trade surplus increased by $39 billion; yet Japan's export volume rose by 4 percent and import volume by 41 percent. In yen terms Japan's trade surplus declined by (Yen) 974 billion ($8 billion). If 1986 is chosen as the base year, then by 1989 Japan's trade balance had decreased by $20 billion (based on second and third quarter annualized data). Changes in Japan's trade surplus are well explained by conventional economic factors: demand growth in Japan and abroad; changes in relative prices and terms of trade; increase in export prices in dollar terms but decreases in yen terms (and decreases in the previously extremely high profits from exports); and relative unit labor cost behavior. The fact that in 1885 Japan's exports were 47 percent higher than imports (in dollars) has meant that imports must grow much more rapidly than exports to reduce the absolute trade deficit.¹

Kuroda is probably too sanguine, and overly optimistic, in asserting that neither Japanese nor U.S. external imbalances will last long. As a percentage of GNP, Japan's current surplus will probably decline to a reasonable level (say about 1.5 percent) within a few years, though without a major increase in oil prices I doubt it will return to zero. More disquieting to some

congressmen is that the absolute surplus measured in dollars is not likely to decline much farther; this however is a political rather than economic issue. However, I am much less optimistic about the willingness of U.S. policy makers to take the needed actions to result in major sustained reduction in the U.S. trade and current account deficits soon.

Kuroda states the argument of some economists that the U.S. global trade deficit and attendant transfer borrowing is not a serious problem so long as those resources go into productive investment is the United States and that the debt continues to be sufficiently small relative to GNP to be readily serviced. However, this misses the point: the problem is not one of economics, but of economic power. I share the common American political judgment that United States power is reduced by persistent current account deficits and increasing foreign indebtedness.

Moreover, Kuroda does not directly address the real and deep American unhappiness about the very slow decrease in the U.S. bilateral deficit with Japan. In large part that is because it is not an economic issue; however, as discussed below, it has become a major American political issue. Movements in the bilateral balance are well explained by conventional economic factors, supplemented by a more micro analysis of Japanese and American trade structures and sectors with declining competitiveness relative to imports. It is not surprising that Japan's recent major growth in manufacturing imports is of labor-intensive goods from developing countries, and that the bulk of American imports from Japan continues to be cars, trucks and parts, and a wide range of industrial electrical goods, from semiconductors, telecommunications equipment, and office equipment, to VCRs. Even so, U.S. exports to Japan have risen rapidly, more rapidly than to the world as a whole. The base year problem is particularly severe, however. In 1985 U.S. imports from Japan were 2.96 times its exports to Japan, so that exports will have to grow more than three times as fast as imports, or absolute levels of imports will have to decrease, in order for the bilateral deficit to decline significantly.

Access to the Japanese Market

Kuroda incorrectly and disingenuously dismisses the issue of access to the Japanese market out of hand. His basic argument is that since 1986 Japanese total imports have grown rapidly (at more than a 20 percent annual rate), manufactured imports even more rapidly (at a rate of over 30 percent), and imports from the U.S. equally rapidly. This is correct, but it is not sufficient.
Rapid growth rates from the very low initial base of imports, especially manufactured imports, are not particularly surprising or impressive. While Japan's import performance since 1986 is indeed very good and to be commended, the real issue is whether the amount of imports will continue in the future to grow rapidly.

Actually, Kuroda could have told a much stronger story about market openness, though in any advanced, complex industrial society including the United States, it is never a simple story. Every country has its distinctive features, yet, private enterprise, free-market democracies share essential commonalities. In many institutional respects, Japan and continental Western European countries are closer to each other than they are to the United States. In general, Japan is not an outlier, outside the range of OECD nations institutional arrangements and economic behavior.

This is clearly the case in terms of governmental barriers to imports. Japanese tariff and quota barriers are low, below those of the European Economic Community.\(^2\) As with the OECD countries in general, Japanese tariffs and quota restrictions on manufactured imports are very low, with occasional exceptional spikes of higher tariffs, as well as government procurement and other regulatory restrictions. Japan has imposed far fewer "voluntary" export restraints (VERs) on its imports than the United States and the European Economic Community. The percentage of imports affected by these and other non-tariff barriers are marginally lower in Japan than in the United States, and considerably lower than the EEC, though the measures are too crude to have great meaning. Japanese agriculture continues to be highly protected by quotas, tariffs, and state trading which imposes high domestic prices on consumers. Yet agriculture is so inefficient and unproductive that Japan is also the largest importing nation of agricultural exports. Even so, the total burden of restrictive agricultural policies on consumers and taxpayers as a share of GNP is higher in Japan (3.2 percent) than in the EEC (2.6 percent) or the United States (1.6 percent).

There are, however, other arguments which suggest Japan's markets are less open to imports than analysis of official barriers would indicate. One commonly cited complaint is the still small share of imports, and especially manufactured imports, to GNP. The other is the

\(^2\) For a recent evaluation of market openness comparing Japan, the United States, and Western Europe, see OECD, *Economic Surveys-Japan, 1988/1989*, (OECD, December 1989), ch. 4. Note particularly Tables 23, 24, and 25, from which the following data are drawn.
persistence of high prices of many imports in Japan following the sharp yen appreciation; the reduction in yen costs has by no means been fully passed through to consumers.

Are Japan's imports, particularly of manufacturers, "too low" in comparison with other advanced industrial nations? Is Japan an outlier in import performance? This is the question posed in empirical tests by Saxonhouse, Leamer, Bergsten and Cline, Balassa, Barbone, and Lawrence -- studies which have attracted attention because of their policy implications. The results are contradictory. The recent evaluation by Srinivasan of the theoretical and econometric foundations of these studies find most are flawed, some seriously so. There is no convincing evidence that the small share of imports in Japanese GNP is due to informal barriers against imports; the Leamer and Saxonhouse studies, which exonerate Japan from the onus of being a low-imports exception to the experience common to other countries, receive higher marks than other studies.

Srinivasan goes on to point out that even if such tests were done rigorously and correctly, and indeed did find that Japanese imports are "too low", the results would be difficult to interpret because the tests are only indirect. There is no way to know whether the results are due to a pervasive set of informal import barriers or a myriad of other possible explanatory factors. Importantly, as Bhagwati, Saxonhouse and I have argued, it may well be that Japan imports too little on the average because it exports too little since its exports (especially in automobiles, VCRs, and other products in which Japanese companies are highly competitive) have been held down by foreign barriers against them.

The persistence of high Japanese prices relative to world prices for traded or tradable goods is a more compelling concern. A number of recent studies have documented the degree to which domestic prices have, or have not, fallen as the yen appreciated. The explanations vary depending on the product. Government regulation is an important part of the story, resulting in high prices for food products, electricity, cigarettes, and the like. A high-price, low-volume, high-profit marketing strategy is pursued by some importers and indeed their foreign suppliers; yen appreciation gains have been taken as profits rather more than as an opportunity to compete through price reductions. We do not yet have clear understanding of these price effects. What are the time patterns of adjustment? Does Japanese price behavior under currency appreciation

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differ significantly from other countries? What are its causes? Why are Japanese consumers so quiescent in paying higher prices for their consumption basket than are people in most countries? I suspect consumer behavior in Japan as elsewhere is asymmetric: more quick to notice and respond to price increases than to potential price decreases that have not occurred.

Every country has its own deep-rooted structural impediments to more efficient economic performance; many impinge on imports. Japan certainly has many such impediments. They show up in two broad ways. The gap between efficient and inefficient sectors (agriculture, very small-scale production and distribution, unskilled labor-intensive manufacturing) is substantially wider in Japan than in the United States, though closer to Western Europe. More importantly, Japan, in contrast to the United States at the other extreme, is not an outsider-friendly society -- even to other Japanese. It takes time and effort and skill to penetrate many Japanese markets even after the product is competitive in price and quality. The current bilateral SII talks aim at reduction in the long run of fundamental barriers to market access, in principle in both countries, but in practice clearly aimed mostly at changes in Japan. In theory, such talks are desirable, but as discussions, not negotiations. In practice they are likely to be dangerous at a time when congress is very impatient with Japan and seeks results as measured by a reduced bilateral trade deficit with Japan. Expectations that SII talks will produce such results in the short run are misplaced, as the USTR clearly understands and articulates but congress may not accept. Over the longer run it may well make sense, as Kuroda suggests, to develop such discussions on a broader national participation basis than purely bilateral.

Yet to ask the question whether Japan’s market is less open than, say, that of France, or of other major industrial nations is to miss the point. Even if Japan is not an outlier -- not so different in trade behavior and performance from other industrial countries -- that does not mean Japan should rest on its laurels and be lax in pursuing further market-opening policies. Neither Japan nor any other major industrial nation has eliminated all trade barriers. The commonly shared objective is to create a system of open, multilateral trade with a minimum of barriers, where those minimum existing barriers, such as national security, in turn are justified and transparent. In my view, countries with good growth, low unemployment, and a current account surplus have a special obligation to reduce their import barriers, though this has not yet been articulated as a formal rule for the international system (as Bhagwati has also argued should be done). This is the reason Japan should be eliminating its remaining trade barriers,
not because its markets are "less open" (especially since the actual evidence on comparative degree of openness is unclear).

The U.S.-Japan Economic Relationship: A New Game

The United States does have a Japan problem, though many Japanese seem unwilling to acknowledge it. It is one both of reality and of perception. And if the United States has a problem, then so too does Japan. The relationship is too important for either to ignore such concerns. Most important, the problem is new, qualitatively different, and much more profound than earlier problems in the bilateral relationship. The key lies in the new reality of Japan's comprehensive economic power and its external projection, particularly into the American economy. And, while economic transactions are typically a positive-sum game, power is relative.

This new reality is very simple: it is Japan's now-great economic power that creates the fundamental source of tension in the bilateral relationship. Note that the tension is generated in the United States, not Japan. It is the United States that is being challenged and is on the defensive. This is not because Japan is different or Americans are racists. It is not even because Japan as a nation exercises its economic power badly or wants to challenge the United States; on the whole, the Japanese government thus far has tried to accommodate Japan's growing economic strength to American national interests. It is simply that Japan has become an overwhelming global economic power, second only to the United States; moreover this power is manifested disproportionately in the total sum of its bilateral economic relationships with the United States.

And it is the sum, synergistically greater than its parts, that makes Japan seem so economically powerful. Japan is now second to Canada as the largest source of U.S. imports, while remaining a distant second to Canada as a market for U.S. exports. Japan is by a substantial margin first as source of manufactured imports, first as the import source of automobiles, steel, semiconductors, machine tools, consumer electronics. Japanese products are more visible in the American market than those from Canada or any other nation. Japanese businesses are a distant second to the United Kingdom in ownership of American business and other real assets; yet, it is more Japanese than British entrepreneurs that are perceived as "buying up America". It is in finance and technology that Japan is perceived as by far the most important foreign player.
To put it this way overstates the case for national economic power. No government can harness and focus its nation's economic power the way it can its military power. Market economies are highly decentralized. They are made up of myriads of discrete individuals, families, companies, and industries, with private ownership of capital and finance, operating in private markets. There is no Japan Inc., nor any America Inc., Indeed, the huge U.S.-Japan economic relationship consists of multitudinous transactions among individual companies and persons; it is the interpenetration of these business relationships at the most micro level that makes the economic relationship so beneficial and strong -- and so costly to lose.

Given this new reality, how should the United States and Japan manage their economic relationship? Very carefully. And in ways different from the way it has been managed in the past. A key issue is not simply how to accommodate the Japanese economic powerhouse as the major new player in the world economy, but how to make Japan a responsible leader in the international economic system.

The American postwar paradigm for dealing with Japan is no longer valid. However, the paradigm has continued to dominate American policy formation until fairly recently, even as the conditions justifying it have been eroding. That paradigm was initially based on a patron-client relationship in which Japan was regarded as having a small and weak economy to be nurtured. By the 1970's, Japan, as a consequence of its rapid economic growth, Japan came to be referred to as a junior partner in an alliance which was deemed of exceptional importance, as its economic performance made it an important new economic player.

Japan's very economic success, together with the relative slowing of U.S. economic performance, undermined and eventually made outmoded the basic economic assumptions of the postwar paradigm for U.S.-Japan relations. This was, however, an evolutionary process; and its implications became clear only in the 1980's. Moreover, as noted, the recent major transformation of the U.S.-U.S.S.R. relationship has substantially reduced U.S. security concerns, making its economic concerns and objectives even more important.

The United States is now debating two new, competing models to become the new paradigms for its relationship with Japan. These models can, somewhat simplistically, be labeled the revisionist model and the mutual dependence model. This is not the place to elaborate the logic of each model and assess their relevance in terms of how best to advance American national interests. Both differ in major respects from the earlier paradigm. To engage in such a
debate is healthy, though recourse to "guilt by association" arguments rather than substance is appalling and should be rejected. We do need to evaluate the ideas of each model in terms of the American national interest. We have muddled along too long based on outmoded and inaccurate premises and perceptions. My prediction is that the mutual dependence, joint leadership model will win the day. Containment is too costly, and probably not attainable.

Yet, how the United States and Japan move from where they are today is unclear. The path certainly is difficult. Indeed, the United States - Japan economic relationship is fraught with danger. Both nations lack vision; both are beclouded by emotionalism and misperceptions. But beyond that, both nations have severe problems both in managing the relationship and in managing themselves. The great challenge in the relationship for the United States is whether it can learn how to share power as well as burdens with Japan. The respective national interests overlap but will not be identical; compromise will be necessary, but will be difficult for the United States. For Japan the crucial issue is what sort of vision it will develop of itself and the world; and how it will exercise power responsibly.

But perhaps the greater challenge lies within the domestic economic, political and social order in each nation. For the United States, the great challenge is how to get its own house in order: raise the domestic saving rate; reduce the federal budget; improve the educational system; increase civilian goods-oriented R&D; enhance corporate competitiveness; expand exports. For Japan, the domestic challenge is equally great and equally difficult: how to transform itself into an open society.