Japan and U.S. Tackle Structural Reform

By Hirofumi Kawano


U.S. President George Bush with Japan's former Prime Minister Sousuke Uno at the Paris summit

Meeting in Paris just before the economic summit this July, then-Prime Minister Sousuke Uno and President George Bush formally agreed to initiate a round of talks to identify and solve structural problems in both countries that impede trade and balance of payments adjustments between Japan and the United States. While there is very strong interest in this Structural Impediments Initiative (SII) on both sides of the Pacific, the two countries have yet to agree on what these structural impediments are and how the effort to dismantle them fits in with the rest of the overall bilateral relationship.

Trading Places author Clyde Prestowitz, a former deputy U.S. trade representative who came to prominence as a hard-liner during the FSX negotiations, commented in a television interview that the SII is going to be a case of America demanding that Japan be more like the United States and Japan demanding that the U.S. be more like Japan. He added, however, that exchanges of this sort are likely to fuel an emotional backlash, and they are not the most productive way to approach Japan-U.S. trade issues.

While not wanting to endorse everything that Prestowitz says, I would agree that the structural problems are deeply rooted in the two countries' cultural and social heritages and that the SII may well face very difficult sledding. In fact, if either of the two countries tries to browbeat the other into changing, there is a very good chance that these talks, initiated to alleviate economic tensions, could well end up exacerbating them.

It is thus worth taking another look at this initiative and asking ourselves how the two sides can work to ensure that it is productive.

In approaching this problem, it is important to dispose first of the contention that the existence of Japanese structural impediments to balance of payments adjustments is proved by the fact that the trade imbalance with Japan refuses to go away even though the United States has made major adjustments in both the dollar's exchange rate and in demand – as demonstrated by the dollar's sharp devaluation, the increased demand for American products overseas, and the progress that has been made on reducing the fiscal deficit.

Even though such claims are sometimes featured in the American media, they should not be the starting point for the SII. If this perception underlies the SII talks it could well lead to increased frustration on both sides and even fuel heightened discord.

Trade imbalances and structural impediments

Economic theory tells us that, given the present world economic regime in which capital flows freely across borders and currency exchange rates are decided by free-market forces, the existence or nonexistence of trade impediments should not have any effect on a country's trade balance. This holds true whether these impediments are border measures such as tariffs and quotas or whether they are domestic factors such as a complex marketing system or a consumer preference for domestic products.

Given the current world economic regime, the only factor that should logically have any impact on a country's balance structure is the macroeconomic balance between aggregate demand and aggregate supply–as seen, for example, in the government's fiscal deficit or the household savings rate.

This question of the relationship between market access impediments and the trade imbalances has long been a major issue in international economics, and there has been ample research yielding clear results. In fact, even United States Trade Representative Carla Hills and Congressman Richard Gephardt have admitted that macroeconomic factors are responsible for 80% of America's trade deficit. Most people understand this intellectually. Because it is difficult to see the direct relationship between macroeconomic factors and the trade balance on a more visceral level, however, attention has focused on the so-called trade barriers and structural impediments.

Yet it would be very dangerous for the SII to fall into this same trap – losing sight of the real causes of the trade imbalance, concentrating solely on distribution structures or business practices, and assuming that the SII should be counted a failure unless these issues are satisfactorily resolved and the results show up in the bilateral trade figures. Of course the agenda for the SII does include such issues as fiscal deficits and household savings rates, but as the two countries' macroeconomic policymakers have stated time and time again, it will take time to settle these issues.

It is thus essential to remember that the SII will not necessarily translate into improved trade figures – even if the talks go well and the two sides are able to agree on what needs to be done.

The 1988 Toronto summit's Economic Declaration had a special Annex on Structural Reforms in which the summit participants called on Japan to pursue further structural reforms in key sectors including land-use policies and the distribution system and called on the United States to increase incentives to save (and thus to curtail consumption). While the Economic Declaration noted that each country is responsible for taking the initiative in implementing its own structural reforms, it is also recognized that these structural reforms will not come easy.

The difficulty of resolving structural problems is vividly illustrated by the land-use problem in Japan. Most people have pointed out that land use in Japan, especially in the Tokyo area and other major urban conglomerations, is a serious economic problem having a major impact on household saving and consumption patterns and industrial investment. Given the outcry, there have been numerous panels and other special groups convened to study the land-use problem, not only within the national government bureaucracy but also at the local government level and even within the ruling Liberal Democratic Party. Yet despite these efforts, no one has yet come up with any surefire remedies. In fact, the more study the issue gets, the more likely it seems that it will be impossible to solve Japan's land-use problems without radically restricting private ownership rights.

It is the same with the distribution system, the other major structural problem cited. Most people recognize that Japanese distribution is complex. But the distribution system has evolved over the years in response to such givens as the Japanese homemaker's preference for fresh food and the fact that distances are relatively short in Japan. As such, it would be wrong to assume that the system is an irrational Rube Goldberg invention. It is clear that Japanese distribution cannot be simplified and rationalized simply by building giant supermarkets and sprawling shopping malls in the suburbs.

The same might be said of American consumer behavior. No matter how much other people may point out that America's future (to say nothing of the trade balance) demands more savings and less consumption, there is no easy answer to the question of what can be done that will actually raise the savings rate.

Japan and the United States have been studying their structural problems for years and years and have been making a hit-and-miss effort to solve them as best they can. The fact that these problems persist despite all of these efforts is eloquent testimony to the fact that they are irrevocably tied to very resilient social and historical factors.

They will not be easy to solve, and looking for overnight solutions or having one party to the talks try to reshape the other in its own image would be counterproductive and might well create the emotional backlash that Prestowitz fears. The only way to approach these structural issues is for Japan and the United States to each be responsible for solving its own problems, and the approach in the SII should be that of each side listening to the other's recommendations not as ultimatums but as valuable advice from a friend.

What the two countries should do

The six issues that the United States has raised for the SII are (i) savings and investment patterns, (ii) land-use policy, (iii) distribution, (iv) price formation, (v) *keiretsu* corporate affiliations, and (vi) exclusionary business practices and antitrust enforcement.

Of the six, all except savings and investment patterns and land-use policy seem to be grounded on a fundamental American perception that the Japanese market is structured to be highly resistant to penetration from overseas and that, as a result, imports are unable to achieve market entry even if exchange rate fluctuation and other factors make them less expensive than domestic Japanese products—and that Japanese companies, because they are assured of high profit margins on their domestic dealings, are thus able to hold their export prices down and to maintain overseas market share.

MITI Minister Hikaru Matsunaga (left) and U.S. Trade Representative Carla Hills: both are closely involved in the Structural Impediments Initiative, which seeks to remove structural barriers to trade.

Although I do not want to go into a detailed analysis of this position here, since I will be taking part in the SII, I would simply point out that Japanese imports have grown very quickly since the yen has appreciated and I find it hard to believe that market mechanisms do not come into play in the Japanese market. It is instructive here to look at some recent Japanese trade figures.

In 1988, Japanese imports grew a whopping $38 billion. Not only was this $38 billion the largest growth anywhere in the world, the 25% growth rate was the highest for any industrial country. By way of comparison, $38 billion is equivalent to the GNP of the Philippines or Greece. Looking just at manufactures, the increase in Japan's imports has been more than 30% per year over the last

Joint Statement by President Bush and Prime Minister Uno on Economic Issues
(July 14, 1989)

President Bush and Prime Minister Uno reviewed a range of bilateral and multilateral economic issues of mutual interest. They reaffirmed their commitment to work closely together to promote continued economic growth with low inflation, expansion of international trade and further reductions in current account imbalances. In this connection, they reaffirmed their commitment to economic policy coordination and noted the progress that had been achieved within this framework toward the above objectives.

In addition, President Bush and Prime Minister Uno agreed to complement the ongoing efforts by launching a new initiative. They agreed on a U.S.-Japan Structural Impediments Initiative to identify and solve structural problems in both countries that stand as impediments to trade and balance of payments adjustment with the goal of contributing to the reduction of payments imbalances. They agreed to establish a joint interagency working group to undertake these talks. The president and the prime minister have appointed tri-chairmen who will chair these meetings which will be held at subcabinet level. These talks will take place outside Section 301 of the U.S. Trade Act. The bilateral working group will present a joint final report to the heads of government within a year, with an interim assessment to be made in the spring of 1990.

three years, which compares very favorably with the 20% plus figure for the EC countries and the approximately 10% for the United States.

At the same time, Japanese imports from the United States were nearly $40 billion in 1988–which was about the same as the total British, West German and French imports from the U.S. Likewise, the year-on-year increase in imports from the United States was $9.5 billion, more than these three countries' combined increase of $9.1 billion. And finally, on a per capita basis, Japanese imports from the U.S. are about the same as British imports, 50% more than West German imports, twice French imports, and nearly three times Italian imports.

These figures are a sure indication that market mechanisms have been at work as Japan responded to the yen's appreciation and shifted to domestic demand-led growth. Yet even as they show that the system works, they should not be taken as an excuse for complacency and a refusal to do anything to ensure that market mechanisms continue to work even better.

If there are artificial means that keep market mechanisms from working in Japan and are thus detrimental to Japanese consumer interests, they should be eliminated. The important thing is to ascertain the validity of this U.S. argument. If the problem is found to exist, and if the two sides can agree on what it means and what should be done, I am sure the government of Japan will take the initiative in acting responsibly to solve the problem.

The Japanese government firmly believes that consumers should enjoy the full benefits of market mechanisms, and this is the message that Prime Minister Toshiki Kaifu has sent President Bush. We are fully prepared to do what is necessary to protect and promote consumer interests–not in response to criticism from the United States or because these market mechanisms are paralyzed in Japan, but rather to enable the Japanese people to enjoy a standard of living commensurate with the economic progress we have made.

The other two issues, savings and investment patterns and land-use policy, are rooted in macroeconomic supply-and-demand balance factors. As numerous observers have pointed out, the fact that Japan lags behind the other industrial countries in terms of social stock has combined with very high land prices to shape Japanese savings and investment patterns. While there is a tendency at present to give fiscal issues priority, the SII may be an excellent opportunity to take the long-term view and to examine what needs to be done in terms of fiscal policy and land-use policy to ensure that Japanese life is more comfortable and rewarding 20 or 30 years down the road.

Suggested remedies

The SII not being designed as a one-way process, Japan has identified seven issues that the United States needs to work on: (i) savings and investment patterns, (ii) investment and production capacity, (iii) corporate behavior, (iv) government regulations, (v) research and development, (vi) export promotion, and (vii) vocational education and training.

All of these issues originate in the belief that American consumer and corporate behavior is extremely short-term and that there is very little attention paid to long-term considerations in corporate behavior patterns or savings patterns. As has already been pointed out by numerous studies, the enormous U.S. fiscal deficit and low savings rate have fed horrendous over-consumption, which has in turn bloated the trade deficit.

Automobiles, for example, are a major Japanese export to the United States, and the imposition of voluntary export restraints and the yen's appreciation have meant sharply higher sticker prices on Japanese cars in the U.S. This should have been a golden opportunity for the U.S. Big Three automakers to regain market share. As reported by both the Brookings Institution and the U.S. International Trade Commission, however, the Big Three took advantage of this to raise their own prices and pad their profits. Not only did they forfeit the chance to regain lost ground, they have not even invested these windfall profits in the capital equipment needed for future competitiveness. Had the U.S. industry responded differently, the U.S.-Japan auto trade picture might be considerably different.

In another example of how U.S. industry is its own worst enemy, the bulk of the materials America exports are still nonmetric – still measured in yards and pounds. Yet with only a few very minor exceptions, the rest of the world has gone metric. Specifications, designs, blueprints and all the rest are done in metric. If the United States is so interested in cracking overseas markets, why does it insist on trying to export nonmetric materials to a metric market? This is like running with weighted shoes and then complaining when you do not win the gold.

Of course, the Japanese are not the first to point these problems out, and they were identified and discussed in the United States even before the start of the SII. In fact, it was awareness of the savings/consumption problem that led to passage of the Gramm-Rudman-Hollings Act and that has prompted so much study of policies to, for example, encourage more productive investment by industry and raise the household savings rate.

Thus Japan will not be going into the SII intending to tell the United States what it needs to do. Not only would such an approach be incompatible with the nature of the consultations–there is no desire to issue ultimatums and demand that the United States mold itself to the Japanese pattern. Rather, it is hoped that Japanese views and insights can shed fresh light on these issues and help the United States find solutions that work.

In sum, the SII consultations offer an opportunity for Japan and the United States to discuss issues that each must be responsible for solving on its own, and they are not a forum for either to dictate to the other. If this last point can be remembered by participants and onlookers alike, the consultations have a very good chance of succeeding.

Hirofumi Kawano is director of the Americas-Oceania Division of the International Trade Policy Bureau at the Ministry of International Trade and Industry.