Better Economic Relations Toward The New Century (The second of four parts):

Missing the Big Picture

By Tsutsumi Tomio

Initially, it may seem rather pointless to attempt another discussion of United States–Japan trade. After all, trade negotiations between Japan and the U.S. remain a topic of near-perpetual debate. In spite of the great deal of energy exerted over this matter, discussions continue to be conducted primarily on a case-by-case basis with no end in sight. This short-term focus leads to a situation in which otherwise highly perceptive observers are often missing the forest for the trees, by not taking the time to step back and to look at the big picture. This may sound an almost painful cliche, but I will demonstrate that it is in fact quite accurate. There is a real need to take an in-depth view of the economic structure in which these individual negotiations are conducted. A need to look not at the trade issues themselves, but at their root causes. What I would like to do here is to briefly, but convincingly, show that when issues of trade friction are examined within a larger context, the picture changes drastically.

Endless debate

Since this analysis will be dealing with subjective vs. objective reality, the stage will be better set if I begin with a quick, though pointed, example of perceptual differences. For those who doubt that there truly is a larger picture lost in trade rhetoric, this should serve as an appropriate case. U.S. trade negotiators believe, and are quite vocal in pointing out, that a continuing Japanese trade surplus with low import ratios (imports as a percentage of GDP) are clear evidence of a closed Japanese market. Such accusations and the Japanese rebuttals should be well known to any who follow bilateral relations.

As for the continuing trade surplus, the Japanese side can easily counter-argue that in the past, the Japanese market, with its huge trade deficit, was definitely not open in comparison to the present, with a trade surplus, and conclude that the trade balance can not be an index of the degree of market openness.

As for the low import ratio, recent figures put Japan's import ratio at 5.6%, with its export ratio at 8.5%, while the comparable U.S. statistics are 9.1% and 7.2%, respectively. We cannot say that there is a significant difference between the two figures—especially after we see that many other trading partners have import ratios in double digits.

What is far less discussed is that Japanese imports on a per-capita basis are quite close to the U.S. level. As of 1994, imports stood at $2,289 per capita for Japan as compared to $2,570 per capita for the U.S. This means that imports per person in Japan stood at a mere $281 less than the U.S. level. A large import gap as evidence of a closed Japanese market cannot be found. Furthermore, the amount per capita that Japan imports solely from the U.S. is higher than per capita U.S. imports from Japan. This may be different from conventional perception, but the facts bear it out. Japan imported $628 per person from the U.S. in 1994, while the U.S. imported $468 per person from Japan. While figures such as these may illustrate the point of differing perceptions, they have not truly reached the heart of the issue.

These kinds of discussion are interesting, but not always convincing and sometimes counter-productive. To reach the heart of this matter, we must return to the fundamental roots of the trade balance. For this, I will need to introduce a more concrete economic model.

The true forces behind trade balances

The most elementary economic model tells us that the true forces behind trade balances are derived from economic fundamentals. I realize that it is not as popular to discuss economic calculations as it is to debate "market forces" or "unfair advantages," but it still remains highly necessary. To fully understand the economic situation being faced, we must return to the core structures upon which the discipline of economics is founded. For the sake of clarity, I will start with the most elementary model and slowly build from there.

Let us begin with the position that demand is equal to supply. This is perhaps the most fundamental, universally accepted economic concept and is traditionally written as Demand=Supply or, more simply, D=S. Demand can be dissected into its component segments as a function of Consumption (C)+Investment (I)+ Exports (X). Likewise, Supply comprises Output (Y)+Imports (M). Therefore, expressed algebraically, D=S could be restated as

$C+I+X=Y+M$.

A simple algebraic rearrangement of these terms would transform this equation into the mathematical equivalent of

$X-M=Y-(C+I)$.

Expressed in words, this states that the trade balance* (exports/imports) is equal to output minus consumption and investment. What this clearly demonstrates is that a trade deficit arises when a country consumes more than it produces, $Y<C+I$. Here, in elementary economic terms, is the root of the U.S. trade deficit. Not in "predatory" or "unfair" Japanese policies, but an imbalance between U.S. consumption and production.

(*Strictly speaking, these exports and imports cover not only commodities but also services.)

Of course, this equation does not show any cause and result relations. So you could say that unfair trade practices in foreign countries cause U.S. consumption to surpass its production, but this sounds as if you are insisting that a dog's tail can wag its body, and

also is far from reality. The left side of the equation, exports and imports, is almost one tenth of its right side in terms of dollar value, so that the domestic economy has an overwhelmingly greater influence upon international trade.

Why does the U.S. trade deficit persist?

If we accept that the U.S. trade deficit exists due to a disequilibrium of macro economic fundamentals, then the question becomes one of why the situation has persisted. If you consume more than you produce, or if you spend more than you earn, you will have to borrow money. In reality, however, you can not continue to borrow money indefinitely. In this regard, there is no difference between individuals and countries.

The textbook solution for dealing with a high trade deficit is to implement a deflationary policy. This policy includes various severe measures such as putting caps on governmental spending, raising interest rates or tightening the money supply in order to reduce the ability to consume in both the public and private sectors. These spending limits reduce demand, which in turn reduces imports while making exports more attractive, and finally draws down the trade deficit.

In the 1950s and 1960s, every time Japan suffered from a current account deficit, the Bank of Japan was forced to implement strict tight-money policies which threw Japan's economy into recession. In the early 1980s, Brazil had accumulated heavy debts deriving from a trade deficit. At that time, the country had to take strict deflationary measures, including a fixed wage level.

Why did the U.S. not follow established economic principles in dealing with this problem, while other countries had to take these painful measures?

The primary reason is that the U.S. dollar remains the dominant international reserve currency, accounting for 62% of reserve currency stocks worldwide. Likewise, an overwhelming 90% of the international transactions conducted by the U.S. are settled in dollars. Essentially, the established strength and utility of the dollar allows the U.S. to continue spending more than it produces and at the same time to minimize the impact of its current debt situation. It does nothing, however, to truly alleviate the problem which continues to plague the U.S.'s international standing.

Under the present circumstances, such a serious deflationary policy has obviously not been attempted in the U.S., and in all likelihood never will be, because political considerations would render it impractical and thus extremely difficult to implement. At this juncture, I would not blame U.S. policy makers, but clearly insist that the main cause of the U.S. trade deficit is simply the product of the macro economic policy they choose to follow, and not the policies of foreign countries.

I & S balance and trade balance

Returning to our equation, we find there is still more to be learned from this model, so let us expand it. With a little further arithmetic rearrangement, the equation now becomes

$X-M=Y-C-I$.

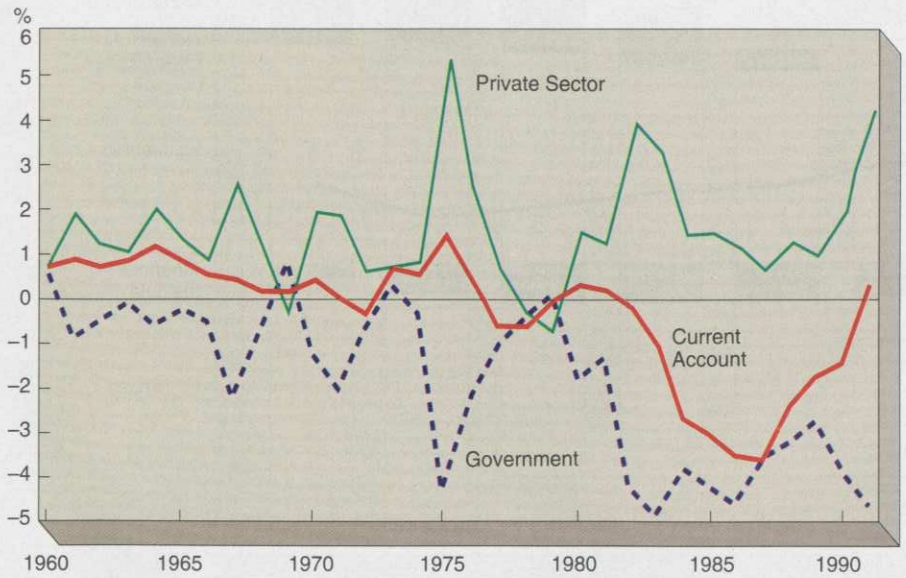
A little deduction will show that output (Y) minus consumption (C) would be equal to savings (S), and the formula could therefore be written as

$X-M=S-I$.

From this we can see that a trade deficit will occur when investment exceeds savings. High savings therefore are at least highly correlated with a positive trade balance, if not equivalent to it. What this equation shows more than anything else, however, is that the trade balance is, in another sense, a product of macro economic choices. By encouraging savings or consumption, governments have the power to directly affect their trade balance through purely domestic macro economic policy.

If this is the case, then to understand the current and future trade balance situation of Japan or the U.S., many productive answers lie not in arguments over "unfair trade practices" by Japan, but in the composition of both countries' savings and investment surpluses

Figure 1: U.S. I & S Balance (Private & Government) and Current Account (vs GNP)



Resources OECD, *National Accounts*

(or deficits)—in short, the I & S balance. To gain further understanding of these situations, we need to examine the I & S balances in the following itemized components of each country's

-government sector,
-financial sector,
-commercial sector, and
-household sector.

Figure 1 shows itemized components of the I & S balance in the U.S. Often cited as the "twin deficits," the I & S deficit in the government sector can be seen to be the main factor accounting for the trade deficit.

Figure 2 shows Japan's case in its sectoral I & S balance, which shows us that the government surplus is the main factor in the recently increasing trade surplus. Furthermore, in the analysis shown in Figure 3, "government" means neither central nor local governments, but refers to the government-run Social Security Fund. The widely known huge public debt of the Japanese government has been more than offset by the surplus in this fund, which by contrast is heavily in the black. This fund, which is roughly equivalent to the U.S. Social Security system, comprises payments in almost equal amounts from individuals, private corporations and government.

In fact, the above-mentioned conclusions sound too simplistic, since the equation does not show which factor is the cause or result. But it is true that government policies have a great deal of impact on both public and private financial activities. A budget itself is a central activity of the government, and its tax incentives for various private activities have a fairly strong influence upon investments or savings in the private sector. While Japan's high ratio and the U.S.'s low ratio of household savings stem partly from national traits, they arise mainly from each country's own long-standing policies.

What is most important here is the fact that the U.S. government has shown a strong determination to reduce its financial deficit, and that the "most rapidly graying society in the world," Japan, intends to reduce its Social Security Fund surplus. If these two things take place in the future, both Japan and the U.S. will then be able to remove a major stumbling block—the trade imbalance problem—which excessively overshadows bilateral economic relations.

Paying attention to the right subject

To drive the point home, let me restate my central point for the final time. What can be drawn from the above analysis is that, when looked at within the larger scope of macro economics, changes in the domestic economy will have a strong impact upon the international scene. It is primarily domestic factors such as savings and consumption rates that affect overall trade balances, not the policies or practices of foreign countries. This is the very case in countries with huge domestic economies like the U.S. and Japan. As closer examination will

Figure 2: Japan's I & S Balance (By Sector)

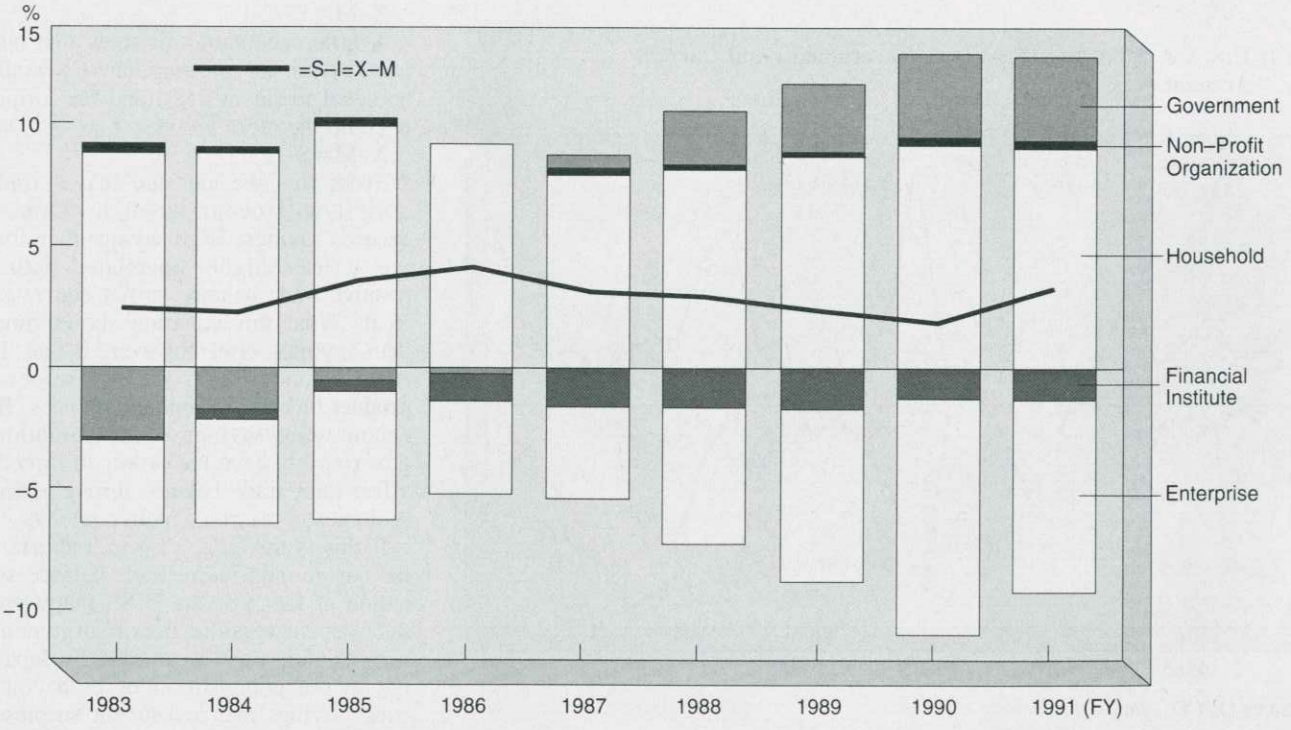
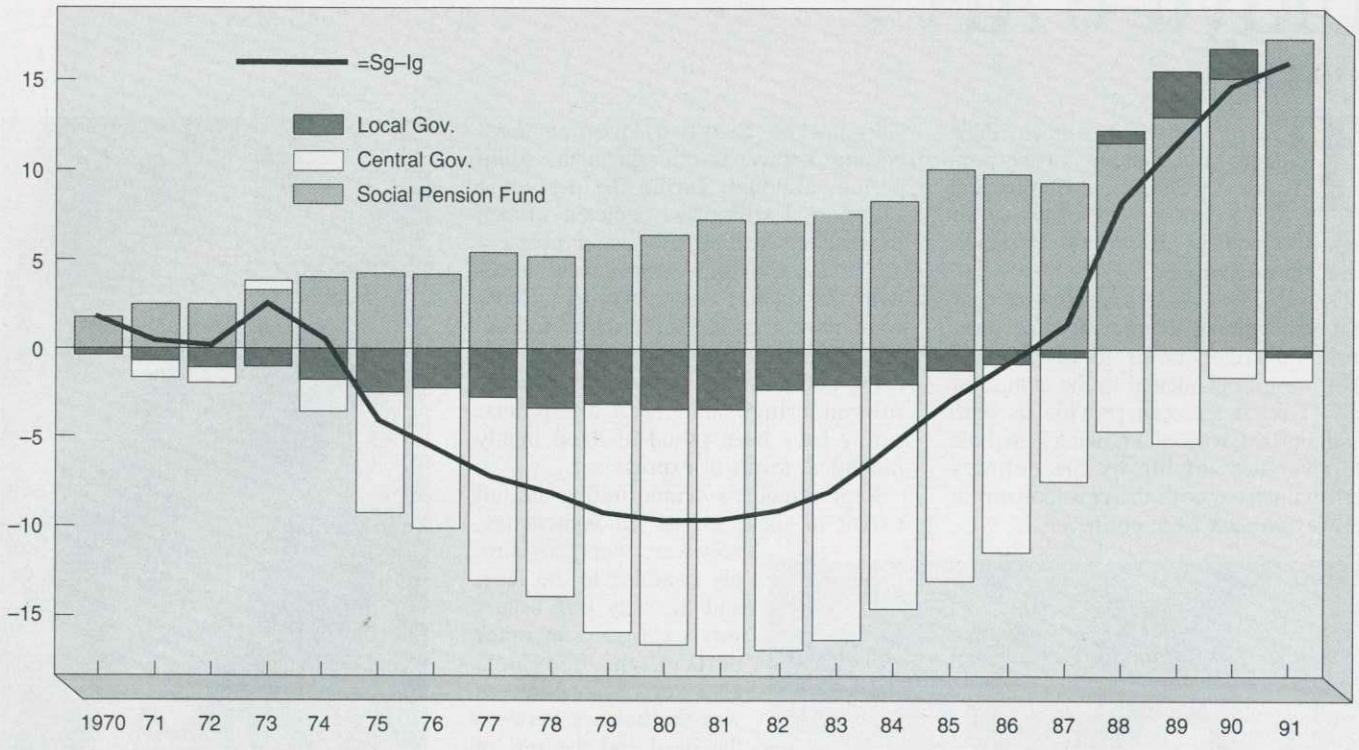


Figure 3: I & S Balance in Government Sector (Japan)



reveal and insightful people in the U.S. have also stated on occasion, 80–90% of the U.S. trade deficit can be attributed to macro economic factors, with the small remainder being a product of trade-related issues. To understand more accurately the trade situation and the forces that impact it, key players on both sides must return to the macro economic fundamentals.

It should be painfully evident by this point that U.S.-Japan trade negotiations often mislead the general public in both countries when they focus excessively on "unfair trade practices" as a main cause of the trade imbalance. Especially in the U.S., the public, including Congress, tends to believe that unfair trade practices in Japan should be removed to overcome the trade imbalance. This leads to doubt that judging from its increasing trade deficit, the U.S. government does not have the ability to open up Japan's "unfairly closed market" with a crowbar, and to doubt Japan's sincerity in its wish to improve trade policy measures. What is most worrisome is the practice of taking advantage of these inadequate approaches as a pretext for protectionism or a breaking down of mutual credibility between Japan and the U.S.

Some may ascribe more political motives to this oversight, and it is after all easier to point an accusing finger at an outside source than to deal with the underlying problems in your own economy. I firmly believe, however, that this is not the case, rather that the idea of getting the trade situation "right" has become so ingrained that the economic fundamentals have been missed. While this analysis has attempted to shape the focus in the direction of looking at the trade situation in terms of economic fundamentals, it has avoided touching on what a more macro economic-oriented approach implies. I have come to the conclusion that this question should be tackled in a much broader context, not only from the viewpoints of trade balances, and have decided that the next article on this subject will be related to the macro economic policy and economic structural reform policy the Japanese government should now take.

In closing, let me say that both Japan and the U.S. must return their attention to critical domestic macro economic policies if both sides hope to find a lasting solution and change trade balances drastically. In this manner, and only in this manner, can the issue of the trade balance be approached in a rational and productive manner. Otherwise the wrong approaches could jeopardize this most important economic relationship between Japan and the U.S.

Tsutsumi Tomio graduated from the Law Faculty of Tokyo University, served as Administrative Vice-Minister of the Ministry of International Trade and Industry, and is currently a Special Advisor to the Japan Economic Foundation, and also to Sanwa Bank.