Clintonomics and Japan-U.S. Trade Relations

By Dr. Sadao Nagaoka

Introduction

President Bill Clinton has placed the rebuilding of the U.S. economy as the focus of his policy agenda. Last year, along with Vice President Al Gore, President Clinton published *Putting People First—How We Can All Change America*, which contained a bold national economic strategy for rebuilding the American economy.

In the first section of this article I will briefly review the main problems that the U.S. economy currently faces. The second section will analyze how the domestic economic policy that the Clinton administration is attempting to implement stacks up. In section three I will discuss the impact this will have upon Japan-U.S. relations.

I. Problems facing the U.S. economy—productivity

As many economists have pointed out, the greatest problem the U.S. economy faces, looking at the long term, is the drop in the productivity rate. Annual labor productivity (in non-agricultural sectors) increased at a rate of 2.4% in the 1950s, but had fallen to 1.3% by the 1960s. By the 1980s the rate had dropped even further, to 0.8% (Chart 1). In an economy where labor productivity growth is low, either the currency is continually devalued, in order to avoid continual fluctuations in the balance of trade, or wage growth must be held lower than that of competing nations. The United States in the 1980s experienced a drop in real wages that was exceptional among developed nations (Chart 1). Further, if an increase of the labor population is taken as one indicator of economic growth, it should be matched by increased productivity. Whether or not the U.S. can maintain and improve its leadership position in the global economy in the future depends upon increased productivity.

Why is the increase in productivity so low in the U.S.? There are two mutual and closely related factors that determine productivity—investment and technological standards.

1. Low rate of investment and the financial deficit

The United States has the lowest investment rate among Organization for Economic Cooperation and Development (OECD) nations. As shown in Chart 2, the ratio of investment to gross domestic product (GDP) in the U.S. is 16%, while the average for OECD nations is 22% and in Japan it is 33%. While the American economy is a bit less than twice the size of Japan's, the total value of investments

Chart 1
Average annual increase in productivity and actual wages in the U.S. economy

	1959-69	1969-79	1979-89
Productivity (non-agricultural sectors)	2.4	1.3	0.8
Actual wages	1.8	0.2	-0.7

Note: Based on hourly wages
Source: Bureau of Labor Statistics

Chart 2
Investment and savings as % of GDP in OECD nations (1990)

	Total domestic investment	Public-sector research and development investment	Total domestic savings	Tax rates	Per capita energy consumption	Infant mortality rate
U.S.	16%	1.9	15%	31.8	2.2	2.0
Japan	33%	3.1	34%	34.6	1	1
Germany	22%	2.8	28%	43.4	1.4	1.6
OECD average	22%		22%			

Note: Level for each country when Japan is 1
Sources: World Bank (1991), OECD (1992) and NSF

Chart 3
Long-term U.S. investment and savings trends (as % of GDP)

	1961-65	1966-70	1971-75	1976-80	1981-85	1986-90
Net capital formation	7.1	7.5	7.0	7.4	5.5	5.0
Net savings	8.2	7.8	7.3	6.9	4.3	2.7

Source: OECD (1992)

falls short.

The most important factor in this low investment rate is the low savings rate in the U.S. At first glance it would seem that even when investment exceeded savings for the country as a whole it would be possible that this gap, the current balance deficit, could be covered by foreign loans. However, currency risk accompanying debits and credits between nations exists and political friction can occur when the deficit in the current account increases. As such we can assume that a country's investment is severely limited by its actual savings over the long term. In the United States the fall in the savings rate in the 1980s was initially financed by a broad deficit in the current balance (3.5% of GNP in 1987), but savings and investment have recently shown signs of balancing out with the drop in the rate of investment.

Savings rates nose-dived in the U.S. in the 1980s. Looking at net savings (capital consumption deducted from savings), the approximately 8% rate of the GDP in the 1960s had fallen to about 7% in the 1970s and sagged even further to 3% or less in the latter 1980s (Chart 3). It is well known that the primary cause that led to this sweeping savings rate decline was the broad deficit in federal finances. This was $290 billion in fiscal year 1992, about 5% of America's GDP of $5.9 trillion.

Along with the federal deficit, the drop in private savings is also a large factor in the U.S. savings rate. Because an increase in the federal deficit signifies a future rise in taxes, the private sector theoretically prepares against this by boosting savings, but in actuality the private savings rate also fell 2% compared to GDP in the 1980s.

2. Technological advances

The second cause is a lag in the rise of technological development. According to OECD estimates, the annual 1.6% investment rate of the 1960s had dropped to 0.6% by the 1980s. The reasons for this are not fully understood, but I will point out three factors that are believed to be important. Technology supply and the development of new technology are considered capital goods and the falling investment rate is, in itself, a major limiting factor in technological progress. Second, investment in research and development (R&D) has not increased. Today Japan and Germany invest a higher percentage of their GDP resources for R&D and public works than the United States (Chart 2).

Third, corporations absorb new technology in order to commercialize and this also greatly restricts ordinary education and in-company training. *Made in America* (1989, MIT) indicated that, first of all, in the area of elementary and intermediate educational achievement American 10-year-olds were in eighth place in science skills among the 15 countries surveyed. The same publication makes the point, "New entrants to the Japanese work force are generally literate, numerate, and prepared to learn. In the U.S. work force, in contrast, employers have discovered high rates of illiteracy and difficulty with basic mathematics and reading in workers with high school diplomas." Regarding in-company training, the book continues, "In the United States individualism and distant or hostile relations between unions, employers and government work against a consensus on company investment in training."

II. Clinton's economic agenda

In order to solve the American economy's greatest problem, stagnating productivity, there is a possibility that the Clinton administration will submit an economic policy package that will concentrate on expanding investment. Next, I will briefly review the five main components of this package.

1. Expanding investment or increasing savings?

In order to expand private investment the Clinton administration is considering implementing investment tax credits and reductions in capital gains taxes for small and medium-sized companies, as well as allocating $8 billion for new public works investment over the next four years in order to improve industrial infrastructure and education. Expanded national savings, however, will be required for these types of investment incentives to have any effect. If a rise in the savings rate is not realized these types of initiatives will either be totally ineffective or, even if there are partial benefits, will end up contributing to the increase in the deficit. In other words if savings are limited there is a strong possibility that the investment incentives granted will end up being completely wiped out by rising interest rates and, further, there is a great danger that expanded public-sector investment will lead to rising interest rates and crowd out private investment. Short-term interest rates had fallen to the 3% level in the U.S. at the beginning of 1992 but long-term interest rates still remained in the 7% range. Actual interest rates, after the deduction of the future inflation rate, will be high, acting as a heavy drag on the expansion of private investment.

Further, if the deficit continues to increase over the long term, in conjunction with expanded investment as it did in the 1980s, I do not think this would be a favorable sign for the United States, which already has a high external debt, and other developed nations that are supplying funds for the development of Third World countries and former socialist nations that are shifting to market economies. There is the possibility that, along with instability of the dollar, this would be a major element of instability in global financial markets. Accordingly, along with a broad reduction in the federal deficit, the implementation of powerful measures to expand savings is an urgent requirement. I would suggest that a plan for expanding savings would be the most reliable and effective method for increasing investment.

2. Halving the federal deficit

During the election campaign President Clinton declared that he would move in the direction of halving the federal deficit over four years. Measures that are being considered for curtailing large-scale tax increases and government overhead include increases in taxes for the highest income brackets, reinforcement of tax levies on foreign corporations, further reductions in national defense costs, increased taxation of energy consumption, cuts in administrative costs, and reform of the Resolution Trust Corporation's (RTC) operations, among others. However, the benefits that might be derived are unclear at this stage.

A drastic reduction in the federal deficit is definitely one of the most important issues that I would like to see the Clinton administration succeed at. There have

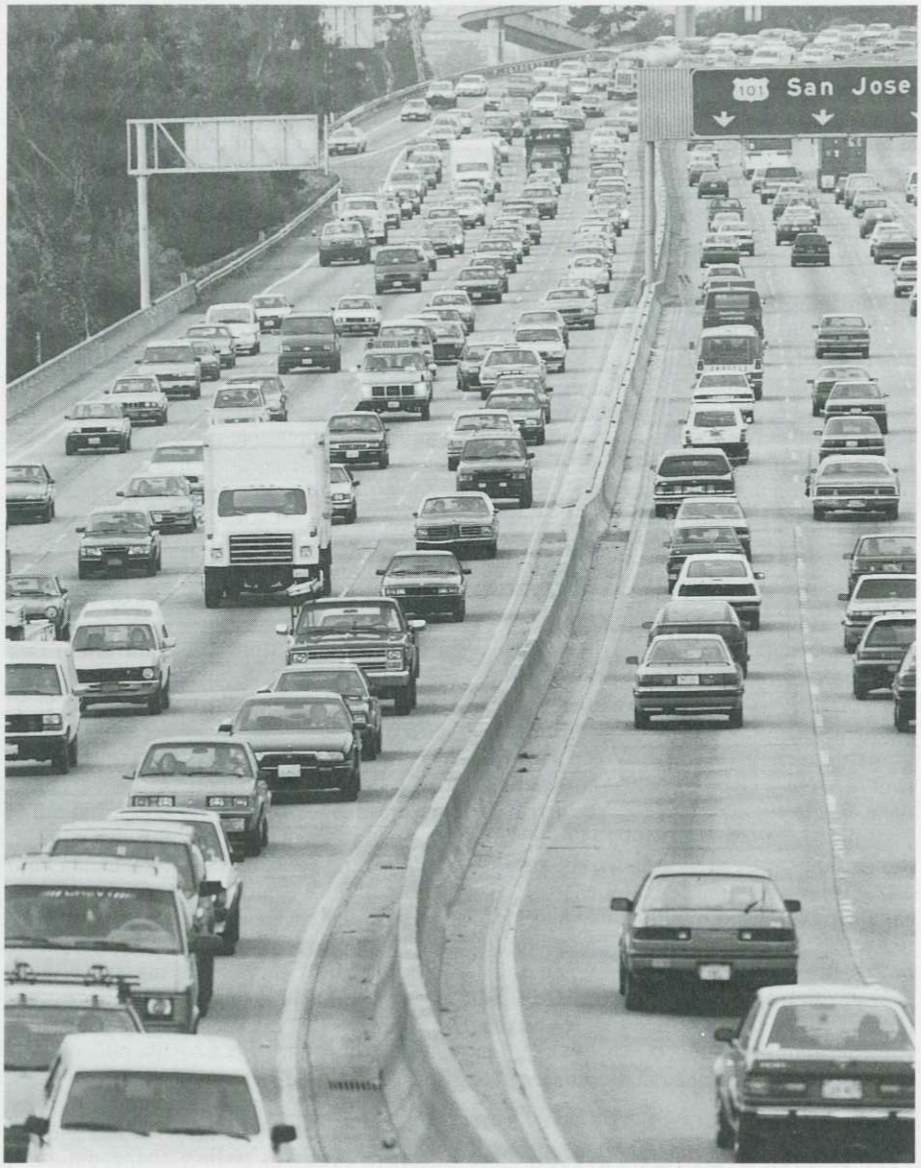

Photo: Kyodo News Service

A typical traffic jam on Route 101. Autos consume excessive amounts of gasoline.

been attempts to drastically reduce the deficit since the time of the Reagan administration, through the Gramm-Rudman-Hollings deficit control law and other measures, but these have all ended as complete failures. This is because, although the Republican administration said it would not reverse the broad-based tax reductions effected by President Reagan or increase taxes while at the same time curtailing expenditures, it was not able to fulfill these goals due to confrontations with Congress.

It is believed that the Clinton administration will also face opposition from a variety of interest groups as far as reductions in tax hikes and government expenditures are concerned. We should be aware, however, that the United States has the lowest tax burden of any developed nation so it is conceivable that taxes could be increased without greatly impairing growth incentives (see Chart 2 for a comparison of Japan, the U.S. and Europe). For example, the highest tax bracket for U.S. federal individual income taxes is a low 31% and energy tax rates are also one-tenth or less than Japan's. A rise in energy tax rates in particular would be greatly beneficial to the federal budget and would additionally contribute to improving the U.S. trade balance, as well as being an environmental measure that would have the effect of curtailing energy consumption. I believe that this is one measure that shows promise. Per capita energy usage in the U.S. is more than twice that of Japan's (Chart 2).

3. Promotion of military conversion and development of public-sector technology

The Clinton administration wants to move forward with cuts in national defense expenditures that are even greater than those made during the Bush administration. Defense expenditures were 5.7% of the GDP in 1991 and even the Bush administration had foreseen that this would drop to 3.8% after five years. Now they will be slashed even further. Cutting defense spending will greatly benefit the federal budget and it is thought that this will also have a major effect in promoting technological developments in the public sector through the revitalization of American industry.

The United States utilizes a large percentage of its highly-educated talent (about 30%) for military R&D purposes. This would have a direct benefit in possibly employing this talent in the public sector. Furthermore, although a major reform of researchers' perceptions would be a precondition, it is conceivable that this could be an opportunity to convert the entire American R&D system from a mission orientation to a market focus.

Further, President Clinton can be assessed by the various adjustment and aid proposals suggested in his book, *Putting People First*, regarding military conversion. Considering that broad reductions in military spending will have highly negative effects on specific regions and industries, it is important that the pain of these types of adjustment periods not be allowed to be tied in with protectionist sentiments throughout the country.

It has also been noted that military conversion will encourage the buying up of companies in the defense industry. There will be a need to quickly delineate regulations that will govern the disclosure of defense technologies developed by the companies concerned, as well as the privatization of their state-owned assets and other types of ownership transfers.

In order to promote public-sector technological development the Clinton administration is already considering keeping the R&D tax credit system in place, developing nationwide technical assistance centers for small and medium-sized corporations, and establishing a Civilian Advanced Technology Agency. It will be interesting to see how these trial measures take shape as the United States attempts to strengthen its industrial competitiveness through activist industrial policies.

4. Investment in human resources

The Clinton administration has placed stress on the development of human resources and is considering broad new initiatives such as assistance to disadvantaged preschoolers, reform of public schools and fostering in-company training.

Also included are measures such as the introduction of national standards, a national education examination and a mandatory allocation of 1.5% of a company's payroll to employee training so that companies can retrain their work force.

The United States has the highest standards in the world in higher education and research organizations, but national education and training levels vary greatly and, as I have already discussed above, Americans on the average do not match the high level of other nations around the world.

In the U.S. this variance is closely linked to widening economic inequalities. The problem does not end there either, because this in turn leads to reductions in returns from investment in higher education and research organizations. If American factory workers are not sufficiently productive the opportunities for new technological development and for products to become commercially successful are limited. Investment in higher education is complementary to investment in general education. I hope that the Clinton administration will be very successful in this crucial area.

5. Health care reforms

A variety of indicators show that the U.S. health care system is less efficient than those of other developed nations. Health care expenditures were 12% of the GDP in 1990, much higher than the 7.5% average of OECD nations. The forecast is for a continued high growth rate which will have the end result of entirely cancelling out cuts in defense spending, a factor in the large federal deficit. Despite increased expenditures the U.S. has a growing infant mortality rate, a declining average life expectancy, and poor performance in other areas of health care. Moreover 15% of the American population, 37 million people, are not covered by health insurance.

In the area of health care services, with the startling information gap between physician and patient and the burden of health care costs to be borne by the patient set at a level far below cost limitations, it is easy for market forces to fail. That the United States, which is probably the least cost-effective in its public health care spending among developed nations, has the lowest ratio of public expenditures to health care expenditures is undoubtedly proof of this. I believe that there is a great deal of room for improvement in the U.S. health care system. I would like to see the Clinton administration move toward the formulation and implementation of drastic reform measures.

III. Policy effects on Japan-U.S. relations

It is entirely possible that the Clinton administration's decision to concentrate on domestic affairs in order to revitalize the American economy could be good news for Japan and the rest of the world.

As I have explained in this essay, the U.S. currently has many domestic economic problems. I believe that drastic solutions are needed to solve the domestic and international problems the U.S. now faces. This is linked to the fact that the United States', one of the most advanced nations in the world, balance of trade is fundamentally in the red and there is rising protectionist pressure against foreign competition. The United States has taken powerful initiatives to liberalize post-war trade and to resolve global economic issues, such as Third World economic development, and I believe that this is what is behind the strength of the U.S. economy.

At the same time, however, there is a possibility that domestic protectionist forces will gain in strength as the U.S. attempts to accomplish great structural changes, such as future cuts in defense spending, in its economy. Moreover, there is the danger that in its commitment to revitalize the U.S. economy the Clinton administration will reach agreements with protectionist forces and provide guarantees for the survival of specific companies and job categories against market competition. Industrial restructuring and revitalization are not compatible with protectionism. This would also undoubtedly have a negative effect on liberalization of worldwide trade.

It will be important for Japan to actively cooperate with the new U.S. administration in order to reduce these dangers, finalize the General Agreement on Tariffs and Trade's Uruguay Round talks successfully, and come up with solutions to the problems facing the global economy. Further, it is important that Japan implement an economic policy that focuses on domestic demand in order to bring about strong economic growth in a reliable manner, thus facilitating a shift from consumption to an export and investment-oriented economy in the United States while at the same time helping the Japanese economy to quickly overcome the current recession. JJTI

Photo: Kyodo News Service

A scene from a U.S. elementary school. Concerns have risen over the educational level of U.S. youth.

Dr. Sadao Nagaoka is professor of economics at Seikei University in Tokyo. Until 1992, he worked at MITI for 17 years.