

The Friction of Convergence

By Kazuo Yoshimura

Japan had a huge trade surplus of \$46.14 billion in 1985. In as much as \$39.51 billion of it was with the United States, it is not too much to say that Japan's trade imbalance is widely perceived to be an imbalance with the U.S. (These figures are based on customs-cleared data released by the Finance Ministry.)

U.S. criticism of Japan, spearheaded by Congress, appears to have subsided somewhat in the wake of the correction of the overvalued dollar following the September 22 meeting of the Group of Five (G-5) industrial democracies and the announcement of a new U.S. trade policy package by the Reagan Administration. But the flames will inevitably be rekindled. Trade frictions have become a political issue, made so in part by the enormous size of the imbalance itself. Moreover, the imbalance can only continue to expand over the short term due to the "J curve" effect accompanying the yen's appreciation, a temporary but no less real phenomenon which fattens the nominal value of exports as exporters mark up their dollar prices to offset declines in yen-based earnings from the U.S. market.

The conclusion comes first. The expansion of the trade imbalance between the two countries is closely related to progress in the integration of the Japanese and U.S. economies. It is a paradoxical relationship: Japanese and U.S. corporate activities based on economic rationalism have deepened bilateral interdependence, widening the trade imbalance and intensifying trade frictions.

In discussing the Japan-U.S. trade imbalance, it is important to separate the microeconomic from the macroeconomic. Microeconomic friction in individual industries is a conflict of interests between companies, and can be adjusted. This is evident from the progress achieved since early last year in market-oriented sector-selective (MOSS) trade talks between Japan and the U.S. on electronics, telecommunications, forestry products, and pharmaceuticals and medical equipment. It is also evident from the growing cooperation between the Japanese and U.S. auto industries aimed at developing the world market, including linkups and production sharing.

But it is much more difficult to cope with macroeconomic friction, and that in-

cludes a trade imbalance which is largely the result of an identity—rather than a conflict—of interests. Put bluntly, the Japan-U.S. trade imbalance will not be resolved easily, and macroeconomic friction will remain even if the frictions in individual industries are eliminated.

Micro integration leading to macro imbalance

Progress in Japanese and U.S. economic integration shows up in trade. Japan's dependence on exports to the U.S. as a share of gross national product (GNP) has risen sharply since the second oil crisis, as has U.S. reliance on imports from Japan for its GNP (Fig. 1). Significantly, machinery accounts for most of the increment in Japanese exports to the U.S. since 1980, and the weight of capital goods and components closely linked to U.S. industrial production has risen sharply. Behind this trend lies a number of Japanese and U.S. corporate activities firmly grounded in economic rationalism.

U.S. multinational corporations have been strengthening strategies since the early 1980s to make the Far East a major production base. Increased direct investment in the region clearly bears this out. Japan, for its part, plays an important role in such strategies, while the high value of the dollar no doubt accelerated the process. More important to U.S. businesses, however, is Japanese production technology, which has been streamlined in the aftermath of the two oil crises, and excellent Japanese labor. In short, U.S. firms are seeking to boost profits by using inexpensive, quality Japanese products.

Such moves are seen in the rising supply of Japanese products to U.S. companies for sale under their own brand names—the so-called original equipment manufacture (OEM) formula—and increased parts procurement from Japan. Supplies under OEM contracts and parts shipments account for as much as 30-40% of Japan's total exports to the U.S., and are increasing relatively rapidly.

On the other hand, the ratio of R&D spending to sales of Japanese corporations has risen along with product sophistication and technological innovation, making the U.S. market ever more important for recovering these massive investments. Businesses can only go high-tech if they can achieve economies of scale, and it is therefore considered indispensable for high-tech Japanese firms to further penetrate the U.S. market. In fact, input-output tables show that significant changes in Japan's industrial structure are due to the relative dominance of industries with fast-rising exports to the United States (Fig. 2).

Japanese businesses enter the U.S. market through direct investment as well as exports. Direct Japanese investment in the U.S. manufacturing sector has ballooned in recent years. A survey issued in March 1983 by the Ministry of International Trade and Industry (MITI) on overseas operations of Japanese businesses showed that their U.S. affiliates had procured a large proportion of their capital goods and parts from Japan, and sold most of the products thus manufactured in the U.S. This indicated that the U.S. was seen as a marketing base rather than a production foothold for Japanese companies, and direct investments there

Fig. 1 Japan-U.S. Export and Import Dependence

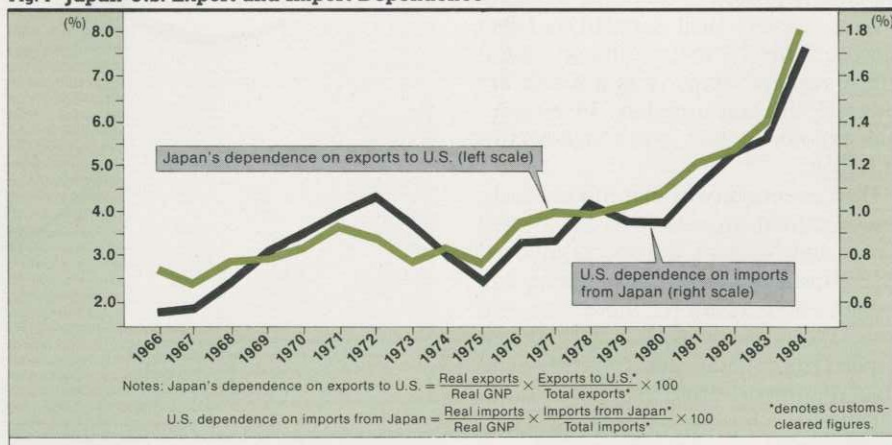
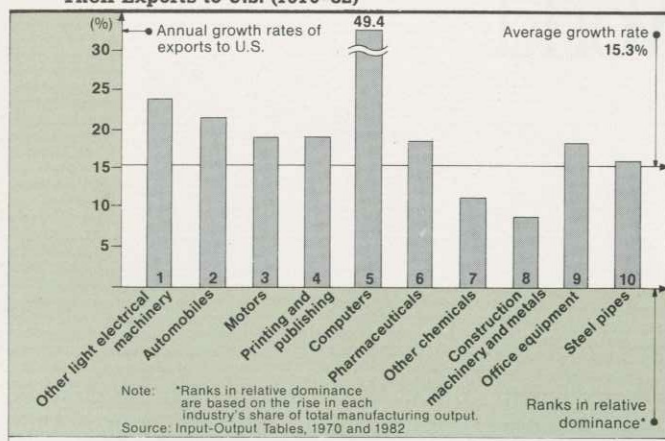


Fig. 2 Top 10 Industries in Relative Dominance and Growth of Their Exports to U.S. (1970-82)



were oriented to increased local sales and market exploitation, ultimately promoting Japanese exports. But this is changing with the rapid increase in local production of late.

The above activities of Japanese and U.S. corporations are the result of reasonable choices, and no doubt support the two countries' economic dynamism. Yet the deepening of interdependency between the Japanese and U.S. economies in this form has helped widen the bilateral trade imbalance and intensify trade friction.

Macroeconomic imbalance: jobs and debt

As pointed out above, the macroeconomic imbalance between Japan and the U.S. mirrors the outcome of rational corporate activities and dynamism. It follows that the trade imbalance itself does not necessarily worsen the increasingly interdependent economies of the two countries. If it does pose a problem, it is when the deficit with Japan worsens the U.S. job picture (causing higher unemployment). It can also be seen as a problem when a continued global deficit in the balance of payments on the current account makes the U.S. a debtor country, with some adverse impacts on its economy.

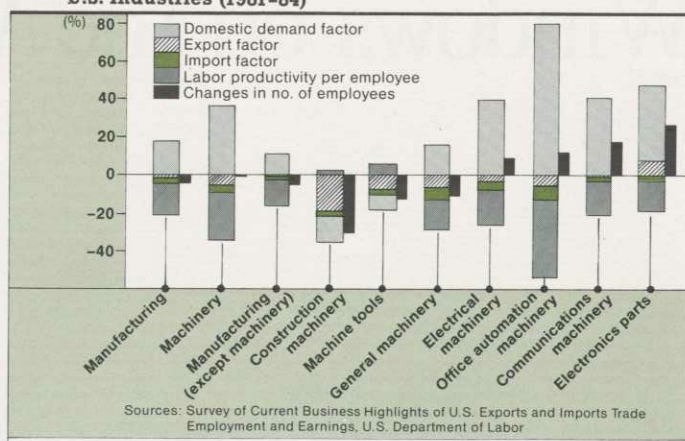
Fig. 3 analyzes factors behind U.S. work force changes by industry during 1981-84, when the deficit with Japan escalated into a major issue in bilateral relations. Most of the increase in Japanese exports to the U.S. during the period represented machinery, as mentioned before. Instead of dropping, however, the number of workers in the U.S. machinery industry leveled off. In some sectors of the industry which saw especially sharp rises in imports from Japan, including electronic components, communications equipment and automated office ma-

chinery, U.S. employment actually increased against a backdrop of brisk domestic demand. Japanese exports to the U.S. in these fields should be given high marks rather than negative ones, for they helped meet supply shortages. Machine tools, construction machinery and other sectors that did experience declines in employment were hit less by imports than by other factors, such as falling domestic demand and exports.

The main U.S. criticism of the macroeconomic trade imbalance is that Japanese exports (and the resulting U.S. deficit) are depriving Americans of jobs. But the above analysis suggests that the impact of Japanese exports on the U.S. employment scene over the past several years has been small, and that it would be more on the mark to credit a shift in U.S. industrial structure toward high technology and services with altering the employment structure. The relationship between trade and employment cannot be explained without taking into account the job-creating effect in the distribution sector of higher imports.

The U.S. is piling up foreign debts. Yet while this could mean various problems over the long term, it is equally obvious that the debts of a key-currency nation should not be discussed on the same terms as those of Latin American and other developing countries. About half the \$300 billion increase in U.S. external debts in 1981-84 stems from a rise in the liabilities of American banks. The second largest factor is direct foreign investment in the U.S., which is not included in liabilities to be repaid. The rise in banking liabilities accompanies the development of a more effective international financial system through expansion of the Euro-money market and other world financial centers, and it would be wrong to regard it as a sign of a weaker U.S. economy. Given further expected development of the international money market in the future, one can hardly expect swollen

Fig. 3 Factors Behind Employment Changes in U.S. Industries (1981-84)



U.S. debts to jeopardize the country's ability to make its external payments.

The above would suggest that the trade imbalance with Japan has not necessarily caused serious problems for the U.S. economy. Nonetheless, psychological and political strains grow every time the newest enormous deficit figures are announced. This U.S. irritation and anger is a reality of macroeconomic friction.

Optimism justified

This article has stressed the positive aspects of the Japan-U.S. trade imbalance—the economic integration between the two nations' economies, and the corporate dynamism behind it. Undoubtedly, the dollar's appreciation from 1980 was one of the primary causes of the U.S. deficit with Japan. It is also true that Japan's industrial structure is not receptive to manufactured imports, and that this has helped expand the trade imbalance. And certainly, the prolongation of this imbalance could spark serious new problems.

But the picture is not all bleak. The overvalued dollar has been brought down considerably since late 1985, and Japan is implementing numerous import promotion measures, including many designed to eliminate structural obstacles to imports. The expansion of services trade, expected to be taken up in a new round of multilateral trade talks, should boost U.S. services exports to Japan. These developments will not resolve the Japan-U.S. trade imbalance in the short run, but should have a major impact over time.

It is important to emphasize the positive aspects of the present bilateral imbalance, and to avoid a situation in which politicizing the size of the imbalance leads to ill-informed policy choices. Policies such as the imposition of import surcharges or export controls can only hurt the corporate dynamism that supports both the Japanese and U.S. economies. ●