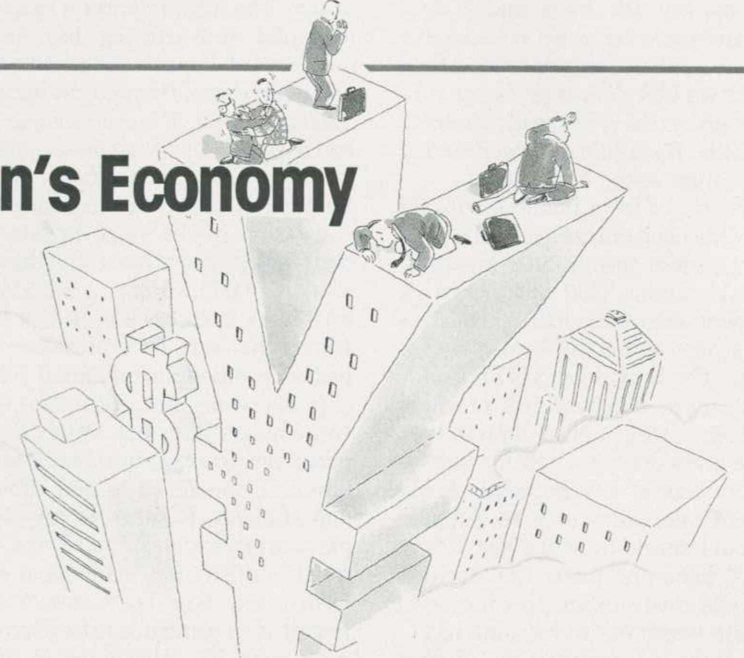
a desirable path for the U.S.-Japan relationship. These studies, which should also look into alternative possibilities, should be undertaken by various sectors in both countries.

Accounting for some 35% of the world's GNP, Japan and the U.S. shoulder a heavy responsibility in the international community. Some serious discussions are needed to find how we might best contribute to the world economy. I think that a Japan-U.S. free trade concept can be an important key to achieving our goals.

Shinji Fukukawa is an adviser to the Ministry of International Trade and Industry and concurrently to the Japan Industrial Policy Research Institute.

Restructuring Japan's Economy

By Ariyoshi Okumura



Two trends characterize the Japanese economy as it stands today. One is what might best be termed the "mini-high growth" now in progress. The other is the structural adjustments in Japanese industry that have made such growth possible.

The dollar has been halved in value against the yen, from ¥240 to ¥120, since the Plaza Accord of September 1985. As a result, Japan's export industries, which conclude 60% of their contracts in dollars, have suffered heavy cuts in profits. On the other hand, the dollar's fall has sharply reduced the cost of the goods Japan imports, because 90% of this import trade is conducted in dollars. Thus the corporate sector has gained enormous premiums from the dollar's depreciation. The sharp drop in world oil prices has brought Japanese corporations equally large premiums.

Today, more than three years after the Plaza Accord, Japan has succeeded in correcting the "mismatch" between its earnings discounts and premiums. This is evidenced by the noninflationary "high" growth Japan is enjoying at both the macro- and microeconomic levels.

This growth pattern is similar to that of the 1960s, but it is somewhat different from the pattern envisioned by the Maekawa Report of 1986. The most striking difference is in working hours. The Maekawa Report called for reducing working hours in the hope that greater leisure time would help improve the quality of life. In reality, working hours have been extended, rather than reduced, during the mini-high growth period.

The main thrust of today's growth comes from the private sector, not the public sector. In other words, personal consumption and private capital investment have led the expansion of the domestic economy. This is an ideal growth pattern. Real GNP has expanded more than 5% a year, while the growth rate of domestic demand has been more than 6% annually, and that of industrial production more than 8%.

The impact is also being felt in the trade balance. Imports have increased at an annual rate of 25%. In fiscal 1988, total import value is forecast to reach anywhere between $170 billion and $180 billion. In contrast, exports have expanded at only half the rate of imports, 12%, with total fiscal 1988 value estimated at some $260 billion. That figure is much smaller than for the United States (an estimated $320 billion in 1988) or even West Germany ($310 billion). The strength of U.S. and German exports followed by Japanese exports suggests that trade in capital goods has increased more than consumer goods against the backdrop of strong capital investment worldwide.

Money image

Judging from these trade figures, Japan's balance of trade should finish fiscal 1988 some $85 billion–$90 billion in the black. This is a fact of life with which Japan will have to live. Part of this surplus is admittedly recycled to the United States, where it serves to finance the U.S. budget deficit, now running at $150 billion a year. Yet the huge trade surplus still creates the perception in the United States and elsewhere that Japan, and particularly the Tokyo market, is awash with money. This enormous trade gap is causing a kind of global "moral hazard," in which other countries tend to feel that they can easily get money whenever they turn to Tokyo.

The problem of the trade surplus inevitably brings to the fore the twin U.S. deficits–namely, the trade and budget deficits. But there are as yet no workable solutions to either. Nagging uncertainty over the twin U.S. deficits gives world financial markets the jitters, with the specter of another Black Monday stock market crash hovering in the background.

These fears of fresh financial collapse are real. One need only consider the position of Japanese institutional investors. Japan holds about $300 billion in U.S. government securities, half of which is hedged against risk in the form of futures contracts. The remaining $150 billion is exposed to the constant risk of paper losses from further dollar depreciation. Japanese investors can sell their dollar futures contracts at any moment should they deem it necessary to do so. Suppose they should decide to hedge just 20% of their $150 billion holdings. That decision alone would create instant pressure to sell $30 billion worth of futures contracts.

Then there is the impact of a further weakening of the dollar on export contracts. Japan's dollar-denominated export earnings are averaging $12 billion a month. Suppose three months' worth of contracts were sold to avoid exchange-rate losses. That would create pressure to sell off $36 billion. Add this pressure to sell in trade transactions to those arising from capital transactions, and the potential dollar sell-off would reach between $70 billion and $80 billion. In this way, huge volumes of dollars are always exposed to potential selling pressures from institutional investors and exporters. Market interventions by the Bank of Japan, involving as they do dollar purchases of little more than $100 million each time, are not large enough to counter such massive selling pressures. The possibility of a massive dollar sell-off in the Tokyo market means that the United States is constantly vulnerable to massive potential inflationary pressure.

The robust expansion of the Japanese economy is creating euphoria in financial markets, but mini-high growth is also giving an acute case of acrophobia to people concerned about a possible overheating of the economy.

The other key trend in the economy today is the restructuring of Japanese industry. The most important result of the industrial restructuring has been the recovery of Japan's international cost competitiveness through drastic cost reductions. This is most notable in the materials industry, where inefficient factories have been closed and large numbers of workers let go during the past two years. In the steel industry, many blast furnaces have been shut down and a total of 44,000 workers, a full 25% of the total work force, have been laid off. As a result, the industry's break-even point has been raised an estimated 5%.

In shedding their redundant workers, corporations have not simply dismissed personnel. Instead, most have been transferred or reassigned to new subsidiaries and affiliates. Because of this Japanese practice of avoiding direct firings, the materials industry has made rapid progress in diversification. For example, the five largest steel companies alone have set up more than 500 subsidiaries in such new fields as electronic materials and ceramics. The drive to turn out higher value-added products has also gained momentum. In the steel industry, heat-resistant, anti-abrasion and anti-corrosion products have all been developed to fill specialized market niches.

Investment abroad

Yet the most striking aspect of the restructuring has been the rapid expansion of direct investment abroad. Assembly and fabrication industries have been the most active in setting up production facilities overseas. Overseas production as a percentage of total production has increased sharply. By 1990 the ratio is expected to reach 85% for audio equipment, 70% for color TV sets, 37% for VCRs and 22% for motor vehicles.

Japanese corporations are rapidly extending their operations across national borders as they build themselves into multinationals. As a result, their ratio of overseas production will continue to rise, and so too will their ratio of parts and materials procured overseas, as well as local content ratios. At the same time, there will be more homeward-bound exports of Japanese products made abroad, a "boomerang effect" that will become even more pronounced if the dollar drops below ¥120.

Under these changing circumstances, conventional industrial and trade policies will no longer work as effectively as in the past, increasing the need to promote policy coordination. In the financial field, where globalization is making its most rapid strides, moves to coordinate policy are already gaining ground as nations work to harmonize their financial activities and regulations. The goal, in short, is to create a "level playing field" in the area of financial services.

The next challenge is how best to create a level playing field in the area of manufacturing as well. This raises a host of problems, such as the operation of antitrust statutes, government deregulation, tax reform and trade controls. In the past, these and other problems have been addressed chiefly in terms of national equal treatment, meaning that foreign companies should be accorded the same treatment as domestic companies. Recently, however, advocates of reciprocity have gained ground worldwide, pushing the principle of national equal treatment into obscurity. What is needed today is a fresh policy reorientation based on the concept of level playing fields.

Individual corporations, too, must work to avoid friction in the host countries in which they operate. They need a new code of conduct to make them good "corporate citizens" in the countries in which they are doing business. In Japan, "corporate citizenship" is a relatively new concept which has yet to be discussed in detail. Yet with more and more Japanese corporations going global, it now looms as a major challenge for the corporate manager.

Ariyoshi Okumura is an adviser to the Industrial Bank of Japan. He was formerly a managing director of the bank.