Economic Relations Between Japan And The United States, 1983

By James C. Abegglen

As the heads of state of Japan and the United States prepare to meet in Tokyo, the economic issues between the two countries that might appear on their agenda appear containable. While economic tensions between the two countries are high, a principal factor in the context for the meeting is heightened concern over relations with the Soviet Union, and an increased awareness in both countries of mutual strategic interdependence. The Korean Air Lines incident, and Japan-U.S. close cooperation in its handling, help provide a favorable public opinion climate for a positive meeting.

Elections are pending in both countries. Each of the outstanding economic issues involves a domestic constituency's interests that neither leader can afford to disregard. Thus, basic or drastic decisions in the economic area appear unlikely. Further, the specific and current economic issues between the two countries appear to be manageable. A series of compromises seems likely, at or before the summit. For example, a continued but expanded quota for Japanese car exports is probable, along with a continuation but expansion of Japanese limits on the import of U.S. agricultural products. No single economic issue appears likely to disrupt the agenda for the meeting of the heads of state.

Yet, common strategic concerns and political compromises over detailed trade issues will not mask the continuing and deepening economic tensions between Japan and the United States. The U.S. trade position is very serious, and as major trading partner and principal source of the U.S. trade problem, Japan cannot escape the resulting tensions. As the U.S. trade position continues to worsen over the coming year, its effects will be much amplified by the run-up to the U.S. presidential election. U.S. employment remains at the 9–10% level, with a concentration in such politically important states as Illinois, Michigan and Ohio. For the first time in history, no U.S. trade union supports a free-trade position. In a historical reversal, the apparent Democratic candidates for that party's presidential nomination are in support of protectionism. The long swing of the United States toward increased protectionism seems likely to accelerate; certainly the rhetoric of protectionism will greatly increase. Japan is the principal target.

The merchandise trade deficit

The U.S. trade problem is becoming very great indeed. It is generally expected that the U.S. deficit on the merchandise trade balance will total $70 billion in 1983. In August 1983, the trade deficit was $7 billion, and thus is already running at an annual rate equal to the $100 billion deficit widely pedicted for 1984. Through the 1970s, a continuing merchandise trade deficit was more than offset by a surplus on the invisibles account, making for a current account surplus. That surplus has been drowned in the trade account deficit, and a current account deficit of $20–$30 billion is expected for 1983. There is currently some concern that under-reporting may distort the current account figures, but in any case, the deficit for the United States on the trade account is large, increasing, and costly for the economy and for its manufacturing entities.

The United States has been in merchandise trade deficit with Japan since the mid-1960s. In August 1983, the deficit with Japan alone accounted for one-quarter of the total U.S. deficit. In terms of non-petroleum merchandise trade, the deficit with Japan is about one-half of the total. It is Japan that has been taking the world market share. Japan's sectors of export success have moved from textiles, to steel, to autos and consumer electronics, to semiconductors. This march to success in successively higher technologies, in which the U.S. had earlier advantage, has come to have an air of the inexorable about it. The high consumer visibility of many of Japan's most successful export items increases public awareness of the issue. It is not remarkable that U.S. concern about trade balances and competitiveness tends to focus on Japan.

Trade tensions between Japan and the United States are not new, or recent. The first major issue arose in the mid-1960s, at the time of the first postwar U.S. trade deficit with Japan, over textiles. The subsequent periods of major problems occurred at the beginning of the 1970s and again in 1977–1978. Each of these coincided with a current account deficit of the United States, and each was largely resolved by exchange rate adjustments that relieved the acute tension.

Some degree of tension is inherent in U.S.-Japan trade relations. As a major importer of food, energy and raw materials, Japan will run a surplus on its merchandise trade account. Since the U.S. market is the largest single market, a good part of that merchandise trade surplus will be with the United States. Further, Japan's continuing shift—a correlate of higher levels of productivity and standard of living—toward higher value-added, more sophisticated products brings Japan in continuing competitive confrontation with the United States, which has heretofore enjoyed advantage in these product areas. The progression from textiles to semiconductors as the focus of the trade disputes demonstrates that shift in Japan's industrial structure.

Japanese response to U.S. complaints

Through the earlier period, the Japanese response to U.S. complaints over trade followed a generally predictable pattern. The United States presented a bill of particulars regarding trade barriers and unfair practices, as seen by the United States. Japan took a "low posture," seeking compromise while lowering trade

barriers and yielding to U.S. demands. Thus over a period of nearly two decades, Japan's trade barriers— initially pervasive and rigorous—have been dismantled. Japan is now about as open to trade as any other country. No country is without trade barriers, and Japan is no exception. But Japan's remaining barriers are by no means unusual nor outside generally accepted international practice. Nor is it clear—indeed it seems unlikely—that total opening of the market in Japan would materially improve the U.S. trade position with Japan.

The fact is that the trade problem with Japan has become more severe as Japan's trade barriers have diminished. In some respects, the nature of the problem has changed. Japan's quite extraordinary success in the export of video tape recorders, now a massive export item, is the result of Japan's unique production position. The current surge in semiconductor exports is taking place in context of world-wide shortages of supply, with Japan a major, and necessary, production source. The trade imbalances are no longer a simple issue of trade barriers, and a more searching solution for the issue must be sought.

The current tensions between Japan and the United States seem different in certain respects from those of the earlier periods. First, the trade issue seems now to be more politicized on both sides. This politicization has been a gradual process, but much of the interaction over trade is now not by professionals on both sides trying to work out quiet solutions. Just as in Japan members of the Diet have moved to the front of negotiations, so in the United States, members of Congress are taking a more direct part.

Related to this politicizing, both as cause and effect, is the increasingly confrontational nature of the interaction. The earlier Japanese tendency to seek compromise is lessened by increased Japanese self-confidence, and a mood that Japan has done its part in seeking solutions; that the problem lies now with the economic performance of the United States and its corporations. In unfortunate parallel, the United States displays an increasing self-righteousness and belligerence in its position, no doubt caused in part by a more general concern over the diminishing relative position of the U.S. economy and a sense of loss of control of economic events. These contrasting moods make cool and constructive analysis and recommendations difficult.

The earlier pattern of Japanese acquiescence to U.S. demands is now not being followed. This does little to improve the state of mind of the U.S. parties to the negotiations. One resulting hazard is the appearance of an increasing number of "hard-liners" on both sides.

Not only does the current period of tension appear to be more politicized and confrontational than earlier, but the duration of the trade tension is more prolonged than earlier. The two periods of major trade crises at the beginning of the 1970s, and toward the end of that decade, each coincided, as noted, with a U.S. current account deficit, and each was eased by exchange rate adjustments. With a diminution of the intensity of the overall issue, it proved possible to focus on more positive aspects of the economic interaction between the two countries. This current crisis has been sustained at a high level since 1981, and shows no sign of early relaxation.

Adjustment of exchange rates necessary

It is becoming quite clear that a moderating of economic tensions between Japan and the United States can only take place through an adjustment of exchange rates. This was true in the earlier periods, and is true today. Exchange rates should move to adjust the effects of trade barriers, whatever they may be, and whichever trade partner is imposing them. At the present time it is clear that there is a massive imbalance in the dollar-yen exchange rate. The persisting high evaluation of the dollar against other currencies is ample evidence of a problem of major proportions.

While there is little prospect of economists agreeing on what exchange rates should be, the effects of inappropriate rates can be noted readily. Assume that an exchange rate of ¥200 to U.S.$1.00 is appropriate. That is a rate at which many Japanese companies state they can compete effectively, and is a rate that Japanese authorities have suggested might be appropriate. The current exchange rate is in the ¥230–240 range. That difference represents a 15 to 20% price advantage for Japanese goods, compared with the price that would normally be charged. It represents a 15 to 20% price disadvantage for exporters to Japan. More bluntly, if an exchange rate of ¥200 is appropriate, then Japanese exporters enjoy a 15 to 20% export subsidy, and importers to Japan confront an additional 15 to 20% tariff barrier.

To the extent that the underlying value of the yen may be higher than ¥200 to U.S. $1.00, then the effects of the exchange rate imbalance on the trade interaction are even greater. The magnitude of this factor quite overwhelms any issue of specific trade barriers, tariff levels, or even competitive capability. There are few products that can surmount a 20% incremental penalty to price. There are few businessmen who cannot be successful given a 20% subsidy.

The basic issue then in current U.S.-Japan economic relations is the issue of exchange rates. On this point, leaving aside a diminishing number of persons who remain preoccupied with the old arguments over trade barriers, there is general agreement. There is also general agreement that the government of Japan is not intervening directly in exchange markets in a way that would make for yen undervaluation. Past this, there is disagreement.

The Japanese position on this basic issue is clear. The cause of the current exchange rate problem is the high level of interest rates in the United States. This is the result of a continuing massive U.S. government budget deficit, and expectations in the money markets of renewed high levels of inflation in the United States. The United States currently pursues a policy of tight monetary policy, and loose fiscal policy. Thus the burden of controlling inflation falls on the Federal Reserve as controller of money supply, and thus interest rates remain high. If the United States were to balance its budget through increased taxes or reduced expenditure, interest rates would fall and the dollar would find its proper valuation level. So, the Japanese argument runs, the current yen undervaluation is a result of the need for the United States to finance its budget deficit through the inflow of funds from abroad, and resulting high interest rates. Correction of this situation, and thus of the massive trade imbalance, depends on U.S. decisions.

In fact, U.S. interest rates are very high compared to those of Japan. Using data from *The Economist* (24 September 1983, pp. 107–108), the U.S. prime lending rate is 11.0% compared with 6.0% in Japan. Similarly, the corporate bond rate in the United States is 12.75% compared with 7.75% in Japan. The difference in both cases is 5%.

These are current rates, not adjusted for inflation. It is argued that real interest rates determine capital flows. Whether this is the case, (and it does seem that most business decisions are made on the basis of current rather than real price or cost) the difference in interest rates persists after adjusting for inflation. Consumer price inflation in the United States year-to-date has been 2.4%, and in Japan, 2.2%. Thus real prime lending rates show a 4.8% differential, and corporate bond rates also are 4.8% higher in the United States than in Japan when inflation-adjusted. Bearing in mind that bankers go to war over rate differences of a fraction of a percent, one can only judge this interest rate differential as being as massive as the trade imbalance that it indirectly, through exchange rates, gives rise to.

Low Japanese interest rates

The issue is more complex, it appears, than a simple case of U.S. interest rates

being high, thus maintaining a high valuation of the dollar. The obverse is the issue of low Japanese interest rates, and the low valuation of the yen. Economic relations between Japan and the United States are dominated by the massive trade imbalance. The trade imbalance is a function of the inappropriate exchange rate level. In turn, the exchange rate level is driven by interest rates, and the flow of funds that results. Is the price of money in the United States too high, as is argued in Japan, or is the price of money in Japan lower than market forces would otherwise dictate?

Money flows to the highest return, unless its flow is blocked. How is it that Japan can maintain such low interest rate levels in a world in which the price of money is higher than it is in Japan? The answer must be that flows of money from Japan are in fact controlled, to a point that maintains low Japanese interest rates, and thus a useful level of exchange rates from Japan's point of view.

The maintenance of low interest rates is very important to the government of Japan. High interest rates would choke off economic growth—in fact, the Bank of Japan seeks the earliest opportunity to lower Japanese interest rates still further. The Japanese government budget has been heavily debt-financed for some years. Higher interest rates would greatly increase the interest burden in the government budget, and make the rolling over of government bond issues much more costly. Thus, key interest rates in Japan—notably the discount rate, rates paid for deposits, and the government bond rate—are set not by the market place, but by government decision.

This control over interest rates can be maintained only by tight controls on the flow of funds from Japan. Given the interest rate differential, there need not be, and at present are no controls on inward flows. Significant inward flows will not take place against a five percent interest differential. However, massive outward flows will take place, unless tight controls are maintained. Thus, the Ministry of Finance exercises very close control at the present time over all categories of outward flow. This allows the maintenance of the low level of Japanese interest rates. If these controls over the outward flow of capital were relaxed, there would be a massive move of Japanese to lend abroad, and of foreign interests to borrow in Japan.

The Japanese government defends its policy of controlling capital flows in terms of preventing further devaluation of the yen exchange rate. This is a self-serving argument that deals only with first order effects of relaxation of controls. In fact, opening the Japanese market to both inflow and outflow of capital would require a raising of interest rates. This is an outcome that the Japanese government is determined to avoid. In terms of maintaining control over the economy, supporting continuing economic growth, and financing current deficits, the Japanese government's position is entirely understandable.

Were Japanese interest rates at world levels, capital flows would tend to be equal, and the current account surplus of Japan would result in a prompt and considerable strengthening of the yen's exchange rate. Under present conditions of capital flow controls, the Japanese government can broadly determine the yen's exchange rate. If the government were determined to increase the exchange rate of the yen—and thus deal with the trade surplus problem—it would either tighten capital flow restrictions to prevent any flow, causing the current account surplus to become a net surplus, or would raise interest rates while freeing capital flows, thus allowing the market to determine the value of the yen.

In fact, no solution to the exchange rate problem is in sight on either side. The United States shows no sign of dealing effectively with its monetary and fiscal problem. Japan shows no sign of addressing the exchange rate problem as a Japanese problem. There is however an increasing view in Japan that interest rates need to be liberalized. This view is being expressed both by the banking community and sectors of the government, who see interest rate liberalization and capital market liberalization as being in Japan's own long-term interest. The government of the United States might well focus more on this issue, lending its weight to those forces in Japan favoring liberalization, rather than persisting in its earlier preoccupations with trade barriers.

Not least of the concerns from the United States' side should be the long-term effects of large interest rate differentials on investment levels. Low interest rates in Japan encourage investment; high rates in the United States discourage investment. The investment differential between the two economies has long been the fundamental determinant of differing rates of economic growth and productivity increase. The current interest rate differential is only exacerbating that long-standing difference. The investment rate difference today is the source of trade tensions of the future.

Liberalization of Japan's capital markets overdue

As Great Britain was earlier, and the United States in its turn, so Japan is now a principal source of capital to a world badly in need of capital flows. Japan moved very rapidly to full membership in the world trading community, but its current restrictions on its capital markets are deflecting flows of Japanese capital to trade in goods only. Japan will find moving to full participation in world capital markets a painful transition, but the burden its trade flows are imposing on Japan's trade partners is insupportable. The time for freeing of capital markets is due.

There can be no constructive resolution of the economic tensions between Japan and the United States until these issues of exchange rates, interest rates and capital flows are resolved. Efforts by private sector companies cannot prevail over the current exchange rate problem. Negotiations over specific trade issues do not come to grips with the basic issue. Both governments must explore ways of bringing into better coordination the fiscal and monetary policies of the two countries.

The partnership between Japan and the United States is of the highest value to both countries and to the world. These continuing trade bickerings erode that partnership. A move by Japan toward closer economic interaction with Asia is taking place, and is appropriate. An accelerating of that move because of rebuffs from the West, to the end of a regional economic bloc, is not in the best interests of Japan or the United States. However, the solution of the current crisis in economic relations depends on Japanese initiatives. As 10% of the world's economy, Japan must now finally participate fully, for better or worse, in the full range of world economic activity. The opening of financial and capital markets is the next and final step. ●

James C. Abegglen is a professor of international business and management at Sophia University and concurrently vice president and director of the Boston Consulting Group, Inc. Abegglen, Ph. D., taught at the University of Chicago and Massachusetts Institute of Technology after post-doctoral study at Harvard University.

He came to Japan in 1945 and returned in 1955 to study Japanese industrial organization and personnel practices as a Ford Foundation Fellow. He has since spent more than half of his time in Japan. Dr. Abegglen has authored or co-authored various books and articles such as "The Japanese Factory," "Management and Worker." Dr. Abegglen is an honorary life member of the Japan Society, New York, and a member of the Council on Foreign Relations, New York, and the Association for Asian Studies.