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THE GLOBAL PAYMENTS IMBALANCE, THE "SYSTEMIC CRISIS" AND JAPAN-U.S. ECONOMIC RELATIONS

Ryutaro Komiya

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Ryutaro Komiya

Faculty of Economics, The University of Tokyo
and
Director General, The Institute of International Trade and Industry

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ABSTRACT

The paper asks what facts constitute the threat of a "systemic crisis" of the world trading system, analyses the factors and conditions which may contribute to fomenting this threat, and discuss how to cope with it.

The paper first discusses what "the world trading system" is, and what have been important changes to the system from the beginning of the post-war period to the present. The world trading system is the worldwide economic system with GATT and the IMF at its central components. Within the framework of such a system, the economies of many countries have developed remarkably since WW II. Global economic integration has been furthered greatly, and thus we can call this "system" a magnificant success.

At the same time, however, a number of difficulties have emerged in the system. Among them, the volatile exchange rate movement, the LDC debt problem, large current account imbalances of Japan and the United States, an increasing number of serious cases of "trade friction", and the growth of protectionism in the U.S. are examined. While the first four problems cannot yet be said to have posed a threat to the world trading system, the last one has been formenting a threat of "a systemic crisis". In the United States, a number of peculiar characteristics of its international economic relations, such as being the key-curency country, an anomaly in its relation with GATT and its very strong bilateral bargaining power, have allowed protectionism in the U.S. to give rise to a threat of a systemic crisis.

Although protectionism in the U.S. is now posing a threat, the fundamental common interests and cooperative relationship among Western countries, especially between Japan and the United States, in the world trading system are still overwhelming. In order to preserve this underlying basis of trust and cooperation, besides requesting self-restraint on the part of the United States, Japan should improve domestic rules and regulations so as to make them transparent and conducive to free trade, make efforts, on the one hand, to liberalize agricultural imports, and, on the other hand, to improve agriculture-related articles of GATT, and maintain a firm commitment to free trade principles.

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INTRODUCTION

There is a view today that the world trading system or the world trading and monetary system is facing a crisis. But what kind of crisis is it? Moreover, is it really a crisis or a critical situation? While I do not believe that the world trading system is currently already in a period of crisis, I feel that in recent years there has been a growing threat of disintegration of the world trading system, and that the potential danger of a "systemic crisis" has risen. The purpose of this paper is to ask what facts constitute the threat of this "systemic crisis", to consider the factors and conditions which may contribute to fomenting this threat, and to discuss how we should cope with this threat.

I will first discuss what "the world trading system" or the world trading and monetary system is, what have been important changes to the system from the beginning of the post-war period to the present, and what kinds of difficulties the world trading system is now facing (Section I). Next I will discuss directions in which the world monetary system could possible be reformed at the present (Secton II). I will then examine the economic situation in the United States and the current account imbalance between the United States and Japan, which, in my view, has become the focal point of the threat of "the systemic crisis" (Section III). I will go on to discuss political conditions and international economic relations which have given rise to protectionism in the United States and which have finally lead to this threat of a crisis (Section IV). Finally, I will discuss prospects of averting the systemic crisis and the role Japan should play in this process (Section V).

I. The Development of the World Trading System

In response to the question "What is the present 'world trading system' or 'world trading and monetary system'?" I would answer that it is the worldwide economic system in which:

(1) GATT (the General Agreement on Tariffs and Trade) and

(2) the IMF (International Monetary Fund)

are its two most fundamental components.

GATT, which came into effect in 1948, developed from bilateral commercial treaties which emerged in the 16th century and were proliferated later in the 18th and 19th centuries. GATT represents a multilateral generalizaton of these treaties. The IMF, ratified in 1947, is an international agreement and an organization for the purpose of international monetary and settlement arrangements and short-term financing. The IMF developed from the gold standard or the gold exchange standard, which had been the global system for settlement of international payments since the latter part of the 19th century.

There are several other important basic factors of the world trading system, such as (3) OECD (the Organization of Economic Cooperation and Development) and (4) IBRD (the International Bank for Reconstruction and Development) and other global and regional multilateral financial organizations which were designed to provide official long-term funds. The OECD is an organization, the members of which are mainly developed countries in Western Europe, North America, and Japan. It exists chiefly for the exchange of information and cooperation in the area of economic policy. The OECD's codes for liberalizaton of invisible trade and for liberalization of capital movements constitute the important rules of the world trading system. One may also say that the "summit meetings" and the meetings of the finance ministers and central bank presidents among the five to seven major countries since 1975 form parts of the core of the world trading system.

Basic Principles of GATT and the IMF

The three basic principles of the world trading system centered around GATT and the IMF are multilateralism, free trade, and non-discrimination with regard to merchandise and invisible trade and international settlement. In this context, free trade means abolishing quantitative restrictions on import and other current account transactions, and making tariff and non-tariff barriers aslow as possible. Non-discrimination means that each member nation grants all other member nations most-favored-nation treatment. Although there are rules that are exceptions to these three basic principles, and in practice there are various de facto deviations from the rules, the aforementioned three basic principles are the main pillars sustaining the system and have been the fundamental framework of the world trading system.

Japan became a member of the IMF in 1952, and in 1964 its status was changed from an Article 14 country to an Ariticle 8 country. Japan became a provisional member of GATT in 1953, and a full member in 1955.[1] Its status in GATT was changed from an Article 12 country to an Article 11 country in 1963. An Article12 country of GATT or an Article 14 country of IMF are those allowed to maintain quantitative restrictions on imports or exchange restrictions for balance of payments reasons. A GATT Article 11 country or an IMF Article 8 country is a member nation that may not establish quantitative restrictions or exchange restrictions on current account transactions for balance of payments reasons. While present membership in GATT and the IMF has risen to include a large number of countries, the present world trading system is centered around the twenty or so advanced industrialized countries which constitute the OECD. Less developed countries, the Soviet Union, the Eastern European countries, and

China participate in the world trading system, but they do so as "periphery" countries. Some of them, such as Soviet Union, are neither members of the IMF nor GATT. Some others are members of the IMF but not GATT. Still others are members of GATT but not the IMF. Furthermore, many of the LDC's and East-block countries are IMF Article 14 or GATT Article 12 or 18 countries. Thus, the number of countries which have reached full membership status (countries which are both GATT Article 11 and IMF Article 8) is not large. Yet, a predominant proportion of the trade and capital movements of these peripheral countries is conducted with the advanced industrialized countries of the West that form the center of the system.

The Development of International Trade

In the approximately 40 years since the establishment of GATT and the IMF in 1947 and 1948, what major changes have taken place within the world trading system? In discussing this issue, I would like to focus on six points.

First, multilateral merchandise and invisibles trade, direct investment, and international capital movement have developed greatly, centered around the Western advanced industrialized nations. This has remarkably accelerated progress toward integration of the world economy. In many countries, international trade has expanded not only faster than the production of tradable commodities but also faster than GNP. The degree of trade dependence (the ratio of export and import to GNP) has risen (see Table 1), and in addition, international economic relations in many areas other than trade have become closer. For example, in the United States, the ratio of import to GNP was only about 3% around 1960, but has exceeded 9%, approaching 10% between 1984 and 1987. As I will explain later, this fact forms one of the factors that are formenting the threat of a systemic crisis. While technological progress in the areas of transportation and communication has contributed greatly to the development of global economic integration, this technological progress itself may be viewed as largely brought about by global economic integration.

Many countries, especially those small countries that do not have balanced factor endowments, benefited greatly from the development of the world trading system. Japan, not well endowed with natural resources, was clearly one of the countries that received most substantial benefits from the world trading system.

GATT has increased its membership from initial 23 countries to 96 countries at present, while the number of member nations of the IMF has risen from 45 countries to 157 countries at present. After 1970, a number of Eastern European countries became members of GATT or the IMF, and a few Eastern European countries that had been members from the beginning or early times but had been "idle members" for a long time became active again. Moreover, China has recently applied for membership in GATT (China is already a member of the IMF), and even the Soviet Union expressed its wish to participate in the Uruguay Round of GATT.

These facts tell the story of the striking growth of the world trading system, and I believe that they demonstrate the success of the three basic principles of the system and the various institutional arrangements embodying them.

Changes in the Relative Positions of the U.S., Europe, and Japan

Secondly, in the last 40 years, there have been very significant changes in the relative positions of the major countries and areas that form the "center" of the world trading system. There have also been large changes in relative technological and industrial capabilities. If we take a look at the economies of the U.S. and Japan in the early 1950s, when Japan became a member of GATT and the IMF, the per capita GNP differential between Japan and the U.S. was somewhere between 1 to 10 and 1 to 15. Considering that the population differential was 1 to 2, the difference in the scale of the two economies was of the order of 20 to 30. At that time, the U.S. economy accounted for over 40% of world production while Japan's share was a meager 1 to 2%. Now the per capita GNP level of Japan and the U.S., when converted at the current exchange rate, is about equal. Present rates of GNP growth, when measured in each country's domestic currency, do not differ much, and at a yen-dollar exchange rate of 140 to 150 yen per dollar, per capita GNP of the two countries is approximately the same. With the yen higher than that range, Japan's per capita GNP is more than that of the U.S. Calculations based on exchange rates put Japan's share of world GNP at 15 to 20%, whereas that of the U.S. has declined to about 30%. Looking at shares of world exports reveals similar trends. Japan's share fell from its pre-war level of 5.3% (1938) to 1.4% in 1950, and in 1955, Japan's share of world exports was still only 2.4%. Nowadays, Japan's share is about 13-15%.

If one looks at changes in the relative importance of countries other than Japan and the U.S. within the world economy, in the past 40 years Western Europe's share first grew due to the reconstruction of Europe under the Marshall Plan, creation of the European Common Market and the EC, but thereafter has fallen somewhat. The Soviet Union's share and that of the Eastern European countries also have followed a similar path.

In Asia, according to some estimates of China's and Japan's GNP in 1950 their GNPs were then roughly equal. Because China's population at that time was about 6.5 to 7 times that of Japan, the per capita GNP of China was about one-sixth to one-seventh as large as that of Japan. Current figures for China's and Japan's GNP reveal that, at the present exchange rate, China's per capita GNP is only one eightieth (1/80) or one hundredth (1/100) of Japan's. The gaps between China and the U.S. in terms of both GNP and per capita GNP have not narrowed much and may have widened. In contrast, the gains by the East Asian NIES (Newly Industrializing Economies) and ASEAN countries in recent years seem quite remarkable.

Japan's rise is not limited to macroeconomic indices like GNP or per capita GNP. Looking at its level of industrial technology also reveals Japan's remarkable progress. Through the 1960's and 1970's Japanese industry gradually improved its industrial technology. First, in such industries as shipbuilding, steel, and household electronics, then in automobiles, machine tools, copying machines, and semiconductors. Initially the U.S. and Western Europe overwhelmingly dominated these industries, but Japan gradually achieved a comparable level of technological capability and then became more advanced in certain areas. Consequently, Japan's export of products of these industries to the U.S. and Europe increased. One of the results was increasing complaints on Japan's exports and "trade friction" cases between Japan and the U.S. and Europe.

The Breakdown of the Old IMF System

Thirdly, in the last 40 years significant changes have also occurred in the international monetary system centered around the IMF. It was only for the period of about ten years from around 1960, when the convertibility of the major West European currencies was recovered, to August 1971, when President Richard Nixon of the United States denounced the gold convertibility of the U.S. dollar, that the initial IMF system, that is, the Breton Woods System, functioned according to its original design. The adjustable peg system, whereby member countries could occasionally adjust the exchange rates of their currencies, collapsed between 1971 and 1973. At the same time, the tie between gold and national currencies was broken.

As an answer to the question of why the old IMF system collapsed, one can point to three fundamental conditions that could not coexist.

(1) The liberalization of international trade and capital movement, especially the liberalization of capital movement.

(2) Each country independently issuing its own national currency and following its own monetary policy, thereby making inflation and interest ratees different from country to country.

(3) Fixity and/or stability of exchange rates.

As will be discussed later (see Section II), each country can freely choose any two of the above three, but not all three.

As for the first point, it should be noted that, the founding members of the old IMF system did not consider requiring member nations to liberalize international capital movement. In addition, the impact of the liberalization of capital movement was not fully understood. During the period when capital movemment was severely restricted, even though there were differences in inflation rates, occasional adjustments of exchange rates were sufficient to keep the adjustable peg system working. However, as capital movement was gradually liberalized and international capital flows increased, the basic difficulties of the adjustable peg system gradually became apparent. The old IMF system broke down when the U.S., the key currency country at the center of the system, decided in August 1971 to stop the gold convertibility of the dollar, in breach of the IMF Agreement. If the U.S. had observed the articles of the IMF Agreement and had changed the par value of the U.S. dollar in view of the "fundamental disequilibrium" in the U.S., the old IMF system might have been able to survive a little longer. However, considering, on the one hand, the increases in international trade and capital movement, and, on the other hand, the fact that each country's economic conditions are <u>always</u> and <u>steadily</u> changing, and sometimes subject to violent fluctuations, the adjustable peg system that allowed for only <u>occasional</u> and <u>jumping</u> adjustments had an inherent shortcoming leading to overburdened situations.

The breakdown of the adjustable peg system and the demise of the gold standard did not mean, however, the ending of the IMF system. What collapsed was the parity system and the gold convertibility of currencies. The IMF's other basic framework, that is, the principles of non-discrimination, multilateralism in international settlement, the liberalizing of current account transactions, and official short-term financing for countries needing such assistance to overcome balance of payments difficulties, still remains today.

Under the floating exchange rate system which followed the collapse of the parity system, exchange rates of major currencies have been subject to large fluctuations. These fluctuations have been thought to produce undesireable effects on international economic relations, especially in terms of how such fluctuations affect trade and domestic industries, and they have become the sources of dissatisfaction who have been adversely affected.

<u>The Erosion of the GATT System</u>

Fourthly, GATT has made enormous progress in some respects. The Kennedy Round (1964-1967) of GATT, which was a response to the European challenge in the form of the EEC, was an epoch-making success in promoting the cause of free trade. The Tokyo Round (1973-1979) also proved to be successful. The GSP (Generalized Special Preference), which was implemented after 1971, contributed to the development of trade of less developed countries and furthered global economic integration by encouraging these countries to participate in the world trading system.

On the other hand, however, an erosion of the fundamental principles of the GATT system has been taking place. Trade restrictions that run counter to the fundamental principles of GATT, especially import quotas by the advanced industrialized nations targeted against exports of manufactured products from late-comer industrializing nations, have increased and proliferated outside the framework of GATT. For example, (1) beginning with the 1957 Japan-U.S. Cotton Textile Agreement, import restrictions on textiles by developed countries were steadily expanded and eventually this lead to the Multilateral Fiber Agreement (MFA) in 1974. Today virtually all major developed countries except for Switzerland and Japan employ quantitative restriction (quotas) systems with regard to their textile imports. (2) Trade restrictions, such as "voluntary export restraints (VER)" or the " Orderly Marketing Agreement (OMA)" were first introduced around 1956. In the beginning, these restrictions only applied to U.S.-bound Japanese exports of light-industry, labor-intensive manufactures. As time went on, however, targets of these restrictions grew to include higher-technology industries such as steel, color television sets and automobiles. Countries involved also grew to include Canada and a number of

West European countries on the importing side, and the Asian NIES and a few other developing countries on the exporting side. Furthermore, (3) "grey zone" arrangements such as "moderation" and "monitoring" by the governments of both exporting and importing countries have also increased. (4) Trade restrictions based on special bilateral agreement such as the Japan-U.S. semiconductor agreement have recently been concluded and implemented. (5) As previously mentioned, most of the developing nations and East European countries, who in terms of sheer numbers form an overwhelming majority of GATT members, still remain Article 18 members of GATT. (6) Moreover, many Article 11 countries, including Japan, have still been imposing a number of "residual import restrictions" in violation of GATT.

Global Payments Imbalance since the 1970's

Fifth, in the 1970's following two oil crises (the first in 1973-1974 and the second in 1979-1980), the OPEC countries and some other oil exporting countries accumulated enormous balance of payments surpluses that resulted in a global payments imbalance. In the 1980's some of the "middle" industrializing countries, such as Brazil, Mexico, and Argentina accumulated staggering current account deficits leading to the present third world debt problen. In the wake of these events after 1983, the current account surplus of Japan and the current account deficit of the U.S. increased enormously. The trade and economic "friction" erupted between these two largest "center" countries in the world trading system.

Among the large current account surpluses and deficits recorded during this period, the surpluses of the OPEC countries did not continue as long as many people had at first feared. In fact, with the fall in oil prices, the OPEC countries' surpluses disappeared. On the other hand, the balance of payments problems of the "heavy debtor" developing countries have yet to improve. The indebtedness of many of these countries has reached unbearable levels and still continues to rise.

Until 1982, for a period of nearly 20 years, the United States' balance of payments on current account fluctuated within 1% of the U.S. GNP. That is, for most years before 1982, the U.S. current account registered either a surplus or a deficit of not more than 1% of U.S. GNP. Similarly, Japan's current account balance remained within 2% of Japan's GNP, either on the plus or minus side. After 1983, however, the U.S. current account deficit and Japan's current account surplus increased dramatically to levels exceeding 3 to 4% of their respective GNPs. The ratio of Japan's current account surplus to GNP has recently been declining since its peak in the middle of 1986, but the Japan-U.S. trade imbalance in dollar terms has not yet been substantially reduced. In addition, due to its large, continuing current account deficit, the U.S., which had been a large capital exporting country until 1980, is now said to have become a net debtor nation. In contrast, Japan, whose net foreign asset-liability position had remained within 1-2% of Japan's GNP until the early 1980's, has suddenly emerged as the world's new giant capital exporting country.

The Rise of Protectionism

Sixthly, in comparison with the 1960's, the world economy today is nearly stagnant, recording lower growth rates of both GNP and trade. Under these circumstances, the political forces of protectionism are gaining strength in many countries. Since 1980, the so-called "trade frictions" between Japan and the Asian NIES on the one hand and North American and West European nations, especially the United States, on the other have become frequent and escalating. In the 1980s, Japan's domestic economy was in recession and its balance of payments on current account turned into a surplus, based upon an expansion of export of medium-to-high technology manufactured goods coupled with a stagnation in its import. Under such circumstances, cases of "trade friction" frequently erupted between Japan and its trading partners. Complaints and greivances against Japan about trade issues from the U.S., West European countries, and nearby Asian countries became frequent, and Japan began to feel that it was surrounded on all sides by adversarial criticisms.

The U.S., in particular, had been unable to reduce its large current account deficits. Protectionism had permeated much more broadly and intensely than in any period of U.S. post-war history, including a number of peak period of its protectionism. For the first time since World War II, the U.S. is now experiencing a situation in which its trade or current account deficit has reached a level never seen before, with no signs of improvement in the near future. Imports suddenly increased as foreign firms now had a competitive edge over U.S. firms in industries considered important or economically "strategic" in the U.S., such as steel, electronics, automobiles, machine tools and semiconductors. As a result, Japan and the Asian NIES, which exported such vital products and recorded enormous trade surpluses vis-a-vis the U.S., became objects of growing anxiety, unrest, and complaints. Gradually these responses transformed themselves into criticisms and censures, and international trade and economic relations grew to involve more and more political disputes. Today "Japan bashing" is quite popular, and protectionism is an important political force. Thus protectionism in the U.S. has gained greater force and become more politicized in the 1980's than during any of the past heights observed in U.S. history after World War II.

<u>What might bring about a "Systemic Crisis"?</u>

As discussed above, within the framework of the "world trading system" that has lasted for over forty years since World War II, the economies of many countries have developed remarkably. Global economic integration has been furthered, and thus we can call this "system" a magnificant success. At the same time, however, a number of difficulties have emerged for which there are currently no simple solutions. Most important among these unresolved problems would be the high volatility of exchange rates under the floating exchange system, the debt accumulation of some developing countries, large current account imbalances in Japan and the U.S., "trade friction", and the growth of protectionism in developed nations, especially in the U.S..

Among these problems which one or which ones are likely to generate a "systemic crisis" of the "world trading system"? In the following sections I shall discuss which of the factors mentioned in the abore possesses such potential.

II. The Debt Problem and The Possibility of Reforming the International Monetary System

In the previous section I mentioned a number of difficult problems faced by the world trading system or the GATT-IMF system. In this section I will discuss the debt problem, the reform of the international monetary system, and the policy to cope with large fluctuations in exchange rates.

Change in the LDC Problem

When the debt problem first became a serious issue in some of the heavily indebted developing countries, such as in Mexico in 1982, major banks in the U.S., Western Europe, and Japan which had been lending to these countries faced the possibility of bankruptcy or at least a serious financial crisis due to an inability to reclaim their loans. This created fears of an international financial panic. Now that a few years have passed, the general feeling among financial experts seems to be that the possibility of such a major financial panic is rather remote. American, European, and Japanese banks that lent heavily to these countries have managed to reduce their loans to heavy debtor countries to moderate levels, at least in relative terms. In the case of Japanese banks, the total amount of loans to these heavily indebted nations is now less than 1% of these banks' total assets. Consequently, the character of the LDC debt problem has changed from one which involves the possibility of an international financial "systemic crisis" to one chiefly concerned with how to rehabilitate the individual economies of debtor countries and put them on their respective new growth paths. In other words, while the debt problem of some of the heavily indebted countries is still an unsolved and serious problem for these countries, the possibility that the debt problem will trigger a world-wide "systemic crisis" has been considerably decreased.

Three National Policy Goals in an Interdependent World

Since the early 1970's, the exchange rates of major currencies frequently and for no apparent reason have undergone large movements under the floating exchange rate system. Many people have suffered and made unforeseen losses and gains. Because these unpredictable exchange rate movements have had significant, unfavorable (as well as favorable) impacts on their domestic economies, it is natural that they have brought about calls for exchange rate stabilization. As I mentioned in Section 1, however, in today's world, countries cannot simultaneously achieve :

(1) liberalization of trade and capital movements,

(2) issuance of national currency and pursuit of independent monetary policies and

(3) fixity or stability of exchange rates.

Each country can freely choose as many as two of these three goals, but attempts to try to pursue all three will eventually result in failure.

Many LDC's, as well as the Soviet Union, East European countries, and China have given up on (1) and have chosen to implement (2) and (3). An overwhelming majority of IMF member nations employ some sort of fixed or managed exchange rate system, and only a few countries use the true floating rate system. Setting the short run aside, it is not easy to fix the exchange rates of a country's currency at some given level over the long run. Among the countries in the EMS (European Monetary System), there are countries which rather severely restrict capital movements. Nevertheless, the EMS occasionally has to change the parity rate for their members' currencies.

Among smaller countries, there are examples of countries abandoning (2). Such a country pegs its currency to the currency of a large neighboring country or to a currency basket. Provided that the real value of the neighboring large country's currency in terms of goods and services is stable, or the value of the currency basket is stable, this may be an advisable choice.

For a major country, however, the best choice is to choose (1) and (2), and, as far as the exchange rate is concerned, let its level be dictated by the market. If Japan or Germany were to decide to go under the jurisdiction of the U.S. Federal Reserve System, and let the Bank of Japan become the Ferderal Reserve Bank of Tokyo and the Deutche Bundesbank the Federal Reserve Bank of Frankfort, and each sent a few Japanese or German officials to the Federal Reserve Board as its members, then the exchange rates among the U.S. dollar, Japanese yen, and German mark could be stabilized. Japan and the U.S., or Japan, the U.S., and Germany, would jointly pursue a unified monetary policy. As is the case now among Federal Reserve banks in the U.S., both the Federal Reserve Bank of Tokyo (The Bank of Japan) and the Federal Reserve Bank of Frankfurt (The Deutsche Bundesbank) would follow policy as decided by the Federal Reserve Board in Washington D.C. Under such arrangements the Japan-U.S. and Germany-U.S. exchange rates could remain stable.

However, Japanese and Germans are unlikely to virtually abandon their national sovereignty over monetary policy, or over the issuance of independent national currencies. All major countries want to maintain the freedom to pursue tight or loose monetary policies in response to macroeconomic policy needs dictated by their own domestic economy. The rates of technological progress and productivity growth differ from country to country. Events such as oil crises and poor and good harvests have varying effects on each country's economy. When external and domestic conditions change and the central banks of individual countries implement independent monetary policies based on separate decisions (not all of which are appropriate) the long run equilibrium exchange rates are bound to shift. Under such circumstances, it is extremely difficult to maintain a fixed exchange rate over the long run. If long run stabilization of exchange rates is difficult, then short run stabilization is also difficult unless capital movements are severely restricted.

Difficulties with the "Target Zone" Approach

People who believe that detrimental effects on domestic economies arise from the high volatility of exchange rates under the floating system have proposed what is called a "target zone" or "reference zone" approach. I believe, however, that under current conditions, such an approach is unrealistic. Nowadays, the level of international capital movements has risen to such an extent that firms, individuals, and institutional investors residing in every country hold large amounts of assets, and owe large debts, both denominated in a number of foreign currencies. In view of this, I can find no convincing strategy which will keep the rates in the exchange rate markets within the designated "zone" when these rates reach its upper or lower limit.

Moreover, there is no clear explanation about how to resolve differences between countries as to where to set the target zone. The national interests of two countries could easily conflict on this matter. It may be recalled that the old IMF system was constructed extremely skillfully and meticulously with regard to this point.

The Best Choice Given the Current Situation

In my view, of the above three goals, (1) though (3), given the current situation, major countries should clearly choose (1) first, and probably also choose (2). There may be some possibility of effectuating (3), if (2) is somewhat sacrificed. In other words, by pursuing "international coordination" with respect to monetary and other macroeconomic policies among the major industrialized countries, it might be possible to increase the exchange rate stability to some extent. I remain highly skeptical, however, as to how successful countries will be in achieving a consensus with respect to "international coordination of macroeconomic policies". Moreover, it is difficult to foresee what level of exchange rate stability can be effectuated in exchange for sacrifice in what degree of autonomy of monetary and fiscal policies.

At least in the case of Japan, for example, choosing to stabilize exchange rates at the expense of domestic price stability is definitely not a wise decision. For example, if the Bank of Japan increases the money supply substantially, the appreciation of the yen can possibly be stopped, or the yen may even start depreciating, but there is a high probability that such a policy will give rise to inflation before long.

In conclusion, there seems to be little prospect at the moment for a fundamental reform of the present international monetary system, especially for a reform of the exchange rate system. Apparently major countries have no choice but to hold on to the current floating system. Even though exchange rates under the floating system are rather volatile, international trade, direct investment, and international lending and borrowing show more vigor nowadays than before the transition to the floating system (see Table 1). This is the result of major industrialized countries choosing (1) and giving up (3). It is hard to believe that changes in exchange rates under the floating system hinder global economic integration significantly more than restrictions on trade and capital movements, which would be necessary under some sort of fixed or "stable" rate system.[2)]

III. The Economics of the U.S. Current Account Imbalance

It appears to me that the rise of protectionism in the U.S. is based on a stylized view of the current U.S. economic situation. The protectionism in the U.S. seems to arise from a view that the current U.S. economic situation is not satisfactory in many respects and that the difficulties stem from losses that the U.S. suffers from international trade and other economic relations. In this section, I will try to discuss the following six issues: (1) The cause of the current account imbalance of the U.S. and of Japan, (2) how to evaluate the seriousness of the U.S. current account imbalance, (3) an assessment of the overall U.S. economic condition and (4) what steps should be taken in order to improve the current situation. With regard to these problems, there is a large perception gap between both American and Japanese economists, on the one hand, and U.S. politicians and journalists as well as dominant public opinion, on the other. There are differences of opinion among economists, however, in regard to (5) perception of the United States' net foreign investment position and (6) the future of the U.S. dollar ; I would like to present my views on these.

Evaluation of the Current Account Imbalance

The U.S. is investing at home more than it is saving as a result of its large government budget deficits, high level of private investment, and low level of personal savings. On the other hand, Japan as a whole is saving more than it is investing domestically due to a high level of personal and corporate savings. The large current account deficit of the U.S. and the large surplus of Japan reflect the macroeconomic situation of these two countries as outlined above. From a macroeconomic perspective, this is nothing unusual. The size of the current account deficit of the U.S. or the surplus of Japan relative to these countries' respective GNP's is not particularly large. Even if we look at only OECD member countries in the 1970's and afterwards, we can find many examples of countries which over an extended time period had current account deficits on a level comparable with or larger than, that of the current U.S. deficits (see Table 2). From a U.S. point of view, the U.S. current acount deficit is not something to make a great fuss about, although it is quite large from other countries' points of view (compared with those listed in Table 2).

The striking fact about the current account deficits of the U.S. and the surpluses of Japan is simply that these two largest economies of the world run continuously large deficits and surpluses. If one considers the each of these two countries independently, one finds that their continuing current account imbalance is not at all a peculiar phenomenon. Although it will not be easy to eliminate or largely reduce the huge current account imbalance of the U.S. and Japan, the imbalance itself cannot be considered a factor which could lead to a "systemic crisis" in the international trade system. I will offer reasons why I understand this is so.

Whether within a national economy or in a would economy, if economic integration is steadily advancing, and regions within a country or countries within the world are tied more and more closely with each other financially, then interregional capital movements will flourish. It is only natural that international capital moves from countries with excess savings to countries with excess investment and that the former are accumulating current account surpluses and the latter current account deficits.

For 50 years, from 1860 to World War I, Great Britain had an annual average current surplus of about 4% of its GNP. During this period, Great Britain supplied capital all over the world and thus contributed to the growth of underdeveloped countries and regions at that time. Immediately after World War II, U.S. current account surpluses were also very large. During the periods in which they had record current account surpluses, both Great Britain and the U.S. had much larger shares of world production than Japan has today. Relative to the size of the world economy at the time, these countries' current account surpluses were larger than Japan's present surpluses.

When one looks at the conditions of world economic development today, Japan's current account surpluses are a very important source of capital supply. From an economic stand point, it is clearly a mistake to regard Japan's surpluses as a disturbing factor to the world economy.

Since 1982, overall economic conditions in the U.S. have been relatively favorable and sound, in my view. The unemployment rate showed a steady decline from a peak of 10.8% in December 1982 to the mid-5% range by the end of 1988. During this time the U.S. also maintained a relatively high rate of growth. Now the U.S. economy has reached a state of nearly full employment, or, one might say, achieved the natural rate of unemployment. Rises in consumer prices have also declined steadily to around 4% from more than 10% at the beginning of the 1980's. This condition is partly due to high levels of imports. It is an obvious mistake to believe that the cause of the Japan-U.S. trade imbalance or current account imbalance lies in the fact that the Japanese domestic market is relatively closed to imports.[3] This can easily be seen from the fact that the bilateral trade balance between the U.S. and nearly all of its major trading partners from 1981 to the present has sharply deteriorated (see Table 3). During this time, there have been a number of countries which have registered relative trade surpluses against the U.S. that are much larger than Japan's surplus in terms of ratio to their GNP.

The U.S. Foreign Investment Position

According to U.S. official statistics, the U.S. net foreign investment position (the difference between U.S. aggregate investments abroad and foreign aggregate investments in the U.S.) was positive for many years but became negative after 1985 (see Table 3). In view of this, it is said that the U.S. has became a debtor country, and that the debt problem has spread from South and Central America to North America. There is also a growing anxiety in the U.S. that before long the U.S. burden of interest payments on its foreign debt will become rather onerous for the American people. Furthermore, some people think that as the U.S. debt accumulates, there is a possibility of a sharp decline in the dollar exchange rate. Although it would be desireable for the United States to reduce the current account deficit so as to avoid a percipitous fall into indebtedness, a heavy burden of interest payments for the U.S. is still a very remote possibility, in my opinion. As a matter of fact, the U.S. payments and debt situation is not so urgent as to require immediate and sudden restoration of the current account balance. The current situation is not as aggravated as some people want us to believe.

First, let us examine this problem from the standpoint of the United States' net foreign investment position. U.S. official statistics measure all assets and liabilities in terms of book value. If these statistics were to measure market values, not only the Unites States' net foreign investment position in 1985 but also at present would be likely to be positive. This conclusion is consistent with the fact that the difference between receipts and payments in the "investment incomes" item in the invisibles account of the U.S. balance of payments was still positive in each year between 1985 and 1987 (see Table 3).

According to economic theory capital stock and income flow correspond to one another. This idea is expressed, for example, in the concept of "human capital". Education or training which is aimed at obtaining or improving knowledge or skills can be thought of as investment in "human capital" for the individual or for the nation. Returns from investment in "human capital" take the form of increases in wage and salary. According to this view, receipts of "investment income" exceed payments when U.S. residents' holdings of assets and claims in foreign countries exceed foreigners' holdings of assets and claims in the U.S.

According to this view, incomes from technologies (i.e. patents, royalties from knowhow, management contracts, copyrights, etc.) is associated with capital assets. Thus, the flow of income from technologies can be thought of as arising from some "intangible" capital stock. The concept of "intangible property" rights reveals the fact that incomes from technologies and other rights come from some sort of capital assets. When these incomes from technologies and other rights are combined with investment incomes, U.S. receipts of investment incomes still far exceed its payments (see Table 3). If one thinks of the Unites States' net international investment position in this light, the United States' position is still a large positive figure, and one cannot view the U.S. as a debtor country.[4)] It will take some time until U.S. net receipts (receipts minus payments) of investment incomes plus technologies incomes become negative.

Secondly, even if the Unites States' net foreign investment position is now about zero and current account deficits of around 3% of GNP continue for another 10 years, the United States' net international investment position will still be much less than 30% of its GNP. If economic growth during this ten year period is taken into consideration the ratio of the net negative investment position to the GNP of the U.S. will be in the range of 25-28%. The burden of interest payments on a net debtor position of this magnitude is only a moderatore one.[5]

Third, one can subtract fixed capital consumption from the gross domestic capital formation to derive net domestic capital formation in the U.S. national income account. If one then subtracts the current account deficit from net domestic capital formation, one obtains a figure for annual change in the "net worth" of the U.S. (see Table 4). Although this figure has fallen substantially in recent years, it has remained positive. This figure indicates that the net worth of U.S. citizens as a whole has been increasing every year. When the U.S. current account balance in the international balance of payments becomes negative, capital funds amounting to that balance are imported from foreign countries. However, capital imports (debt) from foreign countries are used to finance only a portion of U.S. net domestic capital formation.

Financing U.S. Current Account Deficits

In recent years U.S. current account deficits have been financed by importing capital from foreign countries. Some have raised questions, however, as to whether this way of financng U.S. current account deficits can be continued. Fears are entertained in certain circles that with the gradual accumulation of debt owed by the U.S., foreign institutional investors will worry about the possibility of a collapse of the dollar and hesitate to continue to invest in the U.S., especially in the form of portfolio investment in the long-term government bonds. In addition, there is also anxiety that foreign governments and central banks may reduce their dollar holdings in their official reserves and diversify into assets denominated in other currencies. These developments might result in a situation in which the U.S. would be unable to finance its current account deficits.

This kind of worry or anxiety is based on a misunderstanding, however, in my view. It comes from a failure to recognize peculiar characteristics of the U.S. in the world economy. The U.S. has a special position in the world economy in that its national currency, the dollar, is the key international currency. Almost all U.S. imports and exports of goods and services are denominated and conducted in U.S. dollars. When a country's bilateral current account becomes a surplus vis-a-vis the U.S., its residents as a whole are bound to increase (in the amount of the surplus) their holdings of either liquid or long-term financial assets denominated in dollars. Dollar funds corresponding to the U.S. current account deficit immediately and automatically flow back to U.S. financial markets. Or more precisely, these funds only circulate within the U.S. banking sector and financial markets, never leaving the U.S. In this way, the U.S. current account deficit is automatically financed.

When foreign monetary authorities intervene in foreign exchange markets by exchanging foreign currencies for dollars in order to support the U.S. dollar, they invest the dollars that they buy from the exchange market in U.S. treasury bills (and possibly government bonds). Thus, the funds again flow back to the U.S.. Some might wonder whether the case might be different if residents of a country, say Japan, that has a surplus vis-a-vis the U.S., traded dollar-denominated assets for assets denominated in another currency, for instance, German marks, is an effort to diversify the currency composition of their portfolios. This would only mean that now the Germans, instead of the Japanese, would hold the dollar-denominated assets. Moreover, even when residents of a surplus nation purchase U.S. real estate or stocks of U.S. corporations using dollar-denominated liquid assets, dollars automatically return to the U.S. In this case, the U.S. current account deficit is financed by a capital import of long-term nature. Furthermore, even if U.S. residents borrow funds in financial instruments denominated in currencies other than the U.S. dollar, the dollar funds corresponding to the U.S. current account deficit still automatically flow back to the U.S..

The fact that even though the current account deficit continues, all dollar funds automatically return to the U.S. banking sector or financial markets, and the fact that non-residents of the U.S. (foreigners) end up financing the U.S. current account deficits are special characteristics of the U.S. under the current float system.[6] This is in sharp contrast to the old IMF system or the gold standard in which flows of private capital movement were limited, and countries with current account deficits normally had to contract their money supply.

The Question of U.S. Interest Rates

Even though residents of foreign countries automatically finance the U.S. deficit by increasing their investments in the U.S. in an amount precisely equal to that of the U.S. current account deficit, there still remains the question of how two prices will be affected; (1) the U.S. interest rate, especially the long-term interest rate, and (2) the dollar exchange rate. First let us look at the interest rate.

As a result of continued U.S. current account deficits, the amount of dollar-denominated assets posessed by non-residents of the U.S. rises steadily. This foreign investment itself, however, should not have a significant effect on U.S. interest rates. In my opinion, the percentage of dollar-denominated assets in the U.S. owned by foreigners will remain at a low level in the near future. Moreover, there is no a priori reason to suppose that the portfolio preference of non-residents is markedly different from that of residents. Thus, an increase in the proportion of assets held by foreigners should have little effect on the level and the term structure of interest rates in the U.S.

In view of the recent large depreciation of the dollar and the stock market crash (October 1987), there has been a fear that foreign investors, especially Japanese life insurance companies and other institutional investors, will hold back on bidding and investing in long-term U.S. government bonds. If such a retreat takes place, it is feared, U.S. long-term interest rates might rise. Such a fear is entirely unfounded, however. Even if Japanese long-term investors were to refrain from investing in long-term U.S. government bonds, residents of Japan (or non-residents of the U.S.) would make up the difference by acquiring a corresponding amount of liquid dollar-denominated assets. The immediate result would be a rise in long-term interest rates and a decline in short-term interest rates. However, American banks or other financial institutions and intermediaries would, in turn, invest short-term funds in long-term funds. Furthermore, borrowers would shift from borrowing long-term funds to borrowing short-term funds, while those who had surplus funds would shift the funds in the reverse direction. Because short-term and long-term funds are highly substitutable for both borrowers and lenders, if the interest rate gap between long-term and short-term funds were to widen, there would be brisk arbitrage which would work to reduce the gap to the usual level. Consequently, even if Japan's institutional investors were to hold back on investing in long-term U.S. government bonds, it is unlikely that the difference between short- and long-term U.S. interest rates would widen to a noticeable extent.

The Possibility of a Free-Fall of the Dollar

There are some people who believe that although dollar-denominated funds amounting to the current account deficit automatically flow back to the U.S. under the current floating system, if investors, especially non-residents of the U.S., tend more and more to prefer financial assets denominated in currencies other than U.S. dollar, the exchange rate of the dollar vis-a-vis foreign currencies may sooner or later fall as the U.S. accumulates a large amount of debt. There are also people who predict that if the U.S. continues to run current account deficits, these deficits will sooner or later lead to a "free-fall" of the dollar and possibly a collapse of the dollar in the exchange market.

According to the theory of portfolio selection, a rise in the percentage of dollar-denominated assets held in the portfolios of non-residents of the U.S. who are normally risk-averse will result in a demand on the part of these investors for a larger risk premium on dollar-denominated assets. It is theoretically plausible that, due to forces such as the pressure of this demand for a larger premium, the dollar will gradually decline in value against foreign currencies.

For the next 5 to 10 years, however, it is hard to believe that the real exchange rate of the U.S. dollar, apart from its nominal exchange rate, will fall by a large margin due to this risk premium factor. It is even harder to believe that this effect or other forces will cause a sudden collapse of the dollar. The most important reason for dismissing both of these possibilities is that, at present, there are no currencies which can replace the dollar as the key currency of the "world trading system". At present, no currency is more widely used as the vehicle currency for merchandise and invisibles trading and is better supported by extensive and efficient long- and short-term financial markets than the U.S. dollar. Compared with the U.S. dollar, other major currencies have been, and are at present, subject to more extensive exchange controls and financial regulations for both residents and non-residents. In these respects, the present situation differs much from the period during which the U.S. dollar gradually replaced the British pound sterling. When the British pound sterling was devalued in 1949 for the first time since World War II, over 70% of world trade was invoiced in pound sterling, but the U.S. dollar, as compared with the pound sterling, already possessed several characteristics of a superior international currency. Its value over the long run had been more stable than the pound sterling, and it had not been subject to exchange controls much. In contrast to the period immediately after WW II, at present there is no candidate capable of replacing the dollar in the near future.

In addition, if the real exchange rate of the dollar falls substantially against foreign currencies, residents of foreign countries will buy stocks of American corporations and real estate in the U.S.. This investment flow will support the value of the dollar.

Finally, the decline in the real exchange rate of the U.S. dollar over the long run will work to improve the U.S. balance of payments on current account. Then the very problem of U.S. debt accumulation will be gotten under control, and the situation will improve.[7)]

Effective Measures to Reduce the U.S. Trade Deficit

Obviously, it is not wise for the U.S. to let its current account deficit accumulate without limit. U.S. deficits must be reduced in the near future to a level within acceptable limits. An effective means to this end would be the use of macroeconomic policy. The U.S. must use its own monetary, budgetary, and tax policies to control total domestic expenditure ("absorption") and increase total savings thereby improving the U.S. savings-investment balance. If such steps are not taken, even if U.S. trading partners lower tariff and non-tariff barriers against imports from the U.S. and let their currencies drastically appreciate, the U.S. current account deficit will change little. The only change will be in the level and composition of U.S. imports and exports in terms of the kinds of goods and services traded and countries of destination or origin.

U.S. net foreign indebtedness, and the annual excess of U.S. aggregate investment over aggregate savings are respectively equal to the sum of the net debts incurred by all economic units in the United States (all U.S. households, firms, and the federal and local governments), and the sum of the annual excess investment over savings of every individual economic unit. In order to reduce the U.S. current account deficit, the savings and investment balance of these economic entities must be improved. Since investment in the business sector and in infrastructure will contribute to the expansion of productive capacity and improved productivity, generally speaking, reducing investment in these areas may not be wise. In improving the savings and investment balance in the U.S. economy, it is most important that the savings and investment balance of the government sector be improved: that is, the budget deficit be reduced. It is probably imperative that the U.S. Administration and Congress cooperate to raise taxes and reduce federal spending. Furthermore, it is also probably necessary and desirable to improve the savings and investment balance in the household sector by raising the household savings rate and reducing the investment (residential construction) through tax reforms and other measures.

When we think about the future of the U.S. economy, the rate of net U.S. domestic capital formation and the rate of increase in U.S. net worth are parhaps at too low levels in comparison with those of Japan (see Table 4). The U.S. must raise these levels and accelerate domestic capital formation. It is hoped that, by moderating its accumulation of foreign debt, the U.S. will soon make it sure that the level of its current account deficit and foreign debt be kept within acceptable limits relative to GNP.

The U.S. government has often asked foreign governments to pursue macroeconomic policies that will help reduce the U.S. current account deficit. However, this is not only asking too much of foreign nations, but it is also largely meaningless. Every nation has its own macroeconomic policy goals and it must use ("assign") its own macroeconomic measures to achieve them. Moreover, every country faces political limitations on the use of macroeconomic policies.

Furthermore, many simulation studies based upon macroeconometric models indicate that the favourable "cross effects", that is the favourable effects of macroeconomic measures of any one country, say Japan or West Germany have on macroeconomic targets, such as the unemployment and inflation rates, current account balance, or budget deficit, of another country, say the U.S., are very small compared with the "own effects" : the latter is the effects caused by macroeconomic measures of the country in question, say the U.S. For example, when Japan or West Germany expands its domestic demand, this has only a very small effect on U.S. employment, the U.S. current account balance, or the U.S. government budget deficit.

In order to improve the U.S. current account deficit, it is imperative that the U.S. use its own macroeconomic policy effectively to correct the balance between aggregate expenditure and aggregate output --- that is, the balance between aggregate investment and aggregate savings. Without such measures, one cannot expect an improvement in the U.S. curent account deficit.[7)]

Improvement in Industrial and Trade Policies

In the areas of industrial and trade policies, it appears to me that it is not wise for the U.S. to pursue current policies which protect domestic industries and firms by imposing import barriers (including voluntary export restraints which the U.S. urged its trade partners to take) for quite a few industries such as all kinds of textiles, steel, automobiles, electronics, semiconductors, and machine tools. Under protectionist policies, profits and wages tend to be inappropriately high. As a result, firms are inclined to neglect improving productivity, and technological progress is often retarded. The U.S. should take steps to removing its protectionist import barriers with the intention of eliminating them soon. It should revive active competition in its domestic market and accelerate revitalization and restructuring of domestic industries and the relocation of the labor force.

IV. Political Conditions Generating to the Threat of a "Systemic Crisis"

As discussed in the previous section, U.S. economic conditions since the early 1980's have been largely favourable, and U.S. economic performance has been not at all unsatisfactory. The major problems, as I see them, are too high a level of domestic expenditure and the fall in the savings rate, the low level of net domestic capital formation, the deficit of the balance of payment on current account, and the government budget deficit. The accumulation of debt which has accompanied the current account deficit is far from a level that should cause concern. Nevertheless, from the early 1980's a strong protectionist movement centered around the U.S. Congress has gained power, and this movement has been creating "the threat of a systemic crisis" to the world trading system.

If the U.S. Congress legislates protectionist trade laws, the U.S. will begin to deviate from the basic rules of the world trading system. Furthermore, even if such protectionist legislation does not cause immediate deviations from the basic principles of the world trading system, the U.S. is likely to shift to protectionism as the Administration moves in a protectionist direction under the pressure from the Congress, and actions will be taken which are incompatible with the basic rules of the world trading system. There is a great fear that, as such a situation progresses, other countries and regions, especially the EC, will succumb to similar trends. If this reaction were to occur, there would be a threat that barriers to free trade would rise in many countries and proliferate. Violations of as well as deviations from the basic rules of the game of the world trading system would become frequent. In fact, one might say distortions resulting from such frequent violations and deviations are already increasing.

If trade barriers introduced by protectionism and deviations from the basic rule of the game of the world trading system continue to expand beyond their tolerable limits, some incident could lead to a breakdown of the basic framework of the world trading system. At this point the "systemic crisis" will become a reality.

The Sources of Dissatisfaction within the U.S.

The rise of the protectionist movement in the United States may be directly attributable to the rise in U.S. imports since the 1970's, the large scale U.S.

trade and current account deficits after 1983, and the difficulties in reducing these deficits.[8] A threat of a "systemic crisis", however, has been brought about mainly by the rise of protectionism within the U.S. Congress. In the rise of this particular form of protectionism centered on the U.S. Congress, I believe that misunderstandings, misperceptions, and the feeling of frustration among the public as well as politicians have played important roles.

First, looking at the economics behind the policies undertaken in order to improve the trade deficit, one sees protectionists have not properly evaluated the current U.S. economic situation, nor understood correctly the causes of the current account deficit, especially the United States' bilateral deficits vis-a-vis Japan and East Asian countries. Perhaps some people are using these misunderstandings and illusions for their own political purposes.[9]

In other words, "wrong economics" on the part of U.S. Congressmen and leaders of public opinion has played an important role in fostering strong protectionism in the U.S.. If U.S. economists could elucidate the correct understanding of the current U.S. economic situation as well as the proper economics to deal with the U.S. balance of payments deficit, then U.S. protectionist rumblings could be stilled considerably.

Secondly, it appears to me that the U.S. public feels frustrated and discontent with the relative decline in the United States' dominant economic position over the last 40 years as well as the relative rise of Japan. The U.S. bilateral trade balance in the last 10 years has greatly worsened with almost every one of its major trade partners. Despite the fact that relative to their respective GNPs, Canada, Mexico, ASEAN, Korea, Taiwan and several others have often registered larger trade surpluses vis-a-vis the U.S. than Japan (See Table 3), Japan has borne the brunt of the attacks of protectionists in the U.S., especially in Congress. This is partly because Japanese industries in important "key" sectors, such as steel, automobiles, electronics, and machine tools have been able to achieve a superior competitive position relative to the U.S. industries. In the past, these were industries in which the U.S.

competitive advantage had never be challenged. Those that are brought down to an inferior position in open competition often question whether their opponents did not do something "unfair". They tend to appeal to the public about the "unfair" practices of their rivals.

Deep down in the psychology of the American people there seems to exist a strong feeling that they do not want to accept the relative decline in the U.S. economic position in the world, the relative rise of Japan over the past 40 years, the decrease in the gap in productivity and technological sophistication between the two countries, and the reversals of dominance in some sectors.

Intertwined, in a delicate and complex way, with the above psychology of the American people is the fact that the burden of the U.S. defense budget is quite onerous, whereas that of Japan, is very light in terms of defense expenditure relative to GNP.

Thirdly, there is a widespread misperception that Japan's domestic markets are not quite open. It is difficult to measure objectively the relative degrees of openness or closedness of the U.S. or Western European markets. There is no doubt, however, that Japan's markets for both goods and services and for finance and foreign exchange transactions are much more open today that they were in the 1970's. The U.S. current account and trade account were more or less balanced in the latter half of the 1970's until 1983. It is clear, therefore that the closedness of Japanese markets cannot be claimed to be the "cause" for increases in U.S. current account deficits.

As for the closedness of domestic markets, there are various fragmentary pieces of information and anecdotes which tend to indicate that the Japanese markets are more closed than U.S. and West European ones. There are also various fragmentary pieces of information and anecdotes, however, that tend to substantiate the claim that Japanese markets are more open than those of U.S. and European ones. In any event, these stories do not possess much persuasive power. The following facts would suggest that the level of openness of Japan's domestic markets is roughly on par with that of the other major industrialized countries including the U.S.

After 1985, with a very large appreciation of the yen exchange rate, imports of manufactured products to Japan rose very sharply. Imports of manufactured products to Japan from countries and areas such as the EC, Korea, and Taiwan more than doubled between 1985 and 1987 (see Table 6). That a price change can cause such a dramatic increase in imports to Japan strongly indicates that Japan's domestic market is sufficiently open.

Another piece of evidence is an index which represents an evaluation of environments for business activities by foreign enterprises. This index is prepared periodically by an American business consultant based on evaluations of a panel consisting of about 100 businessmen. Based on this index, out of 50 countries for which evaluation is made, in recent years Japan has always been ranked at number 2, only behind Switzerland. In this ranking, for most years West Germany was rated third, the United States fourth, the U.K. around seventh, and France around twelfth to thirteenth. From this data alone, one cannot definitely conclude that Japan's domestic markets are more open to foreign companies than those of the U.S. and the U.K., but it would be fair to say that this evaluation indicates a fairly high degree of openness of the Japanese market for foreign firms. According to well-informed businessmen who operate in Japan, such as those on the above panel, the Japanese market is a "difficult" one for foreigners because of the language, the difference in culture, social customs, etc.. It is evaluated, however, as a market at least as open, and perhaps more open, than the domestic markets of other major industrialized countries.

Conditions for The Politicization of Protectionism

Dissatisfaction, frustration, misunderstandings, and misperceptions regarding the causes of difficulties in domestic and international economic affairs exist to a greater or lesser extent in every country. Moreover protectionism is often an effective means to obtain the support of the electorate in most parliamentary democracies.

In countries other than the U.S., however, the political impacts of protectionist movements are more limited, and thus probably will not expand to generate a threat of "a systemic crisis" of the world trading system. The threat of a "systemic crisis" which is embodied in protectionist movements in the U.S. can be attributed to three peculiar characteristics of U.S. international economic relations. These characteristics are described in the next section.

Peculiar Characteristics of U.S. International Economic Relations

1) The Peculiarity Arising from Being the Key Currency Country

The first peculiar characteristic of U.S.international economic relations arises from the fact that the United States' national currency, the U.S. dollar, is "the" key currency of the world trading system. It is used all over the world as a vehicle currency, a standard of value, and a reserve currency. The status of the dollar as the key currency under both the old IMF system and the present float system stems not from any special legal arrangement in international agreements, but entirely from economic conditions. The special position of the dollar as the key currency is based upon its superior convertibility (absence of exchange controls), long-term stability (over the past 50 to 100 years) of value vis-a-vis goods and services, and the existence of well-developed financial markets for dollar-demoninated funds. This last factor is realized partly by the large size of the U.S. economy and partly by good management by the U.S. financial authorities. The greatest singularity that arises from the use of the U.S. dollar as the world-wide key currency is that nearly all the United States' international trade and capital movements are conducted in U.S. dollars, and that U.S. current account deficits have no potential to give rise to difficulties for the U.S. ininternational settlements, even if they result in cumulative deficits. Consequently, no pressure arises from within the country to improve its own current account.

Countries other than the U.S. keep official international reserves consisting mainly of dollar-denominated liquid assets which can be readily used for international settlement. While one might point out that in recent years proportions of German marks and Japanese yen in the official reserves of various countries have gradually increased, the U.S. dollar is still predominant as a reserve currency. Currencies other than the dollar such as the German mark, Swiss fran, Japanese yen, and the ECU have become more widely used in merchandise and invisible trade and in the issuance of international bonds. However, the U.S. dollar is still predominant as vehicle, reserve and intervention currencies. When a country other than the United States accumulates current account deficits, except in the case in which there is a steady inflow of long-term capital, the country's official international reserves are reduced. In such a case, the country will have to change their macroeconomic policy in order to improve the current account and/or to look for short-term financing from the IMF or elsewhere. The IMF then asks the deficit country's government to tighten its monetary and fiscal policy so as to reduce the current account deficit and turn it into surplus within a few years.

In the case of the U.S., however, even though large current account deficits persist, short- and long- term capital funds denominated in dollars flow into the U.S. Thus, the U.S. faces no difficulty in international settlement. Moreover, since almost all of U.S. trade, investment and financial transactions are carried out in its own currency, fluctuations of the dollar exchange rate give rise to relatively little immediate inconvenience to U.S. firms. Today, as there is no longer the convertibility of dollar for gold, there is no need for the U.S. government to borrow funds from the IMF. Thus, even if the U.S. current account deficit continues and some knowledgeable people feel the need to improve the U.S. balance of payments on current account pressures to change macroeconomic management and thus impove the balance of payments - pressures which would arise sooner or later in other countries - does not arise from within the U.S. Hence there is no chance for the IMF to make strong demands on the U.S. to tighten monetary and fiscal policy.

Thus, there is a remarkable asymmetry here. The U.S. has the largest quota in the IMF and thus has the largest voting power. When countries such as the U.K., France, and Italy in the past, and Brazil, Mexico, and Argentina more recently experienced large current account deficits, the IMF advises and/or requests that these countries tighten their fiscal and monetary policy and improve their balance of payments. When the IMF requests a country to take a stringent macroeconomic policy, there are usually strong dissatisfaction and adverse reactions within the country, but the deficit country has no choice but to more or less follow what the IMF dictates. For the U.S., however, especially now that gold convertibility has been abolished, because it possesses and issues the key currency, this sort of pressure does not operate. The IMF has no chance to intervene.

There are some people who assert that in the present float system, the mechanism to adjust current account imbalances and recover balance of payments equilibria is lacking or that such equilibriating power is extremely weak. Such an assertion is, however, missing the mark since under both the old IMF system and the present float system, the basic mechanism for recovering the balance of payment equilibrium is such that the country which runs into balance of payments disequilibrium tries to get out of it by undertaking an appropriate change in its own macroeconomic policy. In this way, the country that has developed a current account imbalance has been eliminating the imbalance.

When countries other than the U.S. wish to improve or eliminate their current account deficit, the improvement is achieved primarily through that country's own macroeconomic policy. Of all the countries that have had large current account deficits, the U.S. is the only country that has severely criticized surplus countries and made strong demands through bilateral negotiations that surplus countries take some sort of macroeconomic measures which are thought to contribute to improve the U.S. deficit. Here, too, recent trends in the U.S.

seem to be quite peculiar.

2) U.S. Congressional Disregard of GATT

The second peculiar aspect of U.S. international economic relations is that, due to certain complicated circumstances at the time of the conclusion of GATT, the U.S. Congress did not ratify or in any way approve GATT as an international agreement, while the legislatures of most member countries other than the U.S. have approved GATT as an international agreement, giving it the status of an international treaty or status comparable to a treaty. Since then the U.S. Congress has, in general, taken the position that GATT can be ignored. In the U.S. the legal status of GATT thus remains no more than an administrative agreement signed by the President on his responsibility as head of the executive branch.

For this reason, in the U.S. during periods of heightened protectionism since the 1960's, a large number of bills that clearly violate GATT have been introduced in the Congress, such as the Burke-Hartke Bill, the so-called Local Contents Bills, the "Reciprocity" Trade Bill, and various protectionist articles of recent trade bills. The U.S. is the only member country of GATT whose legislature has behaved in such a manner.

If the legislatures of GATT member countries which ratified the GATT were to pass a law that directly contradicted GATT, without having gone through the procedures of withdrawing from GATT, such an action would constitute a violation of the theory of legislation of a sovereign state. Consequently, the possibility that such a law will emerge is low. In the case of the U.S., however, in spite of the fact that it is one of the major leading members of GATT, its Congress can at any time legislate laws that directly violate GATT.[10)]

Thus the U.S. Congress has a tendency to disregard GATT in its legislative activity, and herein lies a possibility of development of a "systemic crisis."

3) Strong U.S. Bargaining Power

The third peculiarity that characterizes recent U.S. international economic relations is the fact that the U.S. has strong bargaining power in its bilateral negotiations, and does exercise it. The U.S. government can conduct bilateral negotiations to obtain concessions from other countries under the threat that protectionist sentiment is very strong in its Congress. In this way, the U.S. government has been successful in obtaining concessions --- often unilaterally --- through bilateral negotiations. Other countries, on the other hand, generally do not have much negotiating leverage vis-a-vis the U.S. Other countries can do little even at a critical moment when the U.S. violates a very important international agreement, as it did when the old IMF system collapsed. The following three cases exemplify the powerful bargaining power of the U.S.

First, it is controversial whether the Japan-U.S. semiconductor agreement, which had been concluded by the strong demands of the U.S. government, included major violations of GATT. Few would disagree, however, that the retaliatory measures unilaterally taken by the U.S. government in response to an alleged violation of the agreement by Japan, namely the implementation of an extremely high tariff of 100% on goods which have no connection at all with semiconductors, was a clear violation of GATT. In view of the United States' strong negotiating position in this matter, the other country, in this case Japan, could not take effective countermeasures.

Second, recently the U.S. government, claiming that the Brazilian computor software policy was unfair and that it hurt the interests of U.S. industry, demanded the Brazilian government to legislate a law to protect the computor software copyrights. During the negotiation with Brazil, the U.S. government announced that it will institute an import embargo on 66 Brazilian products such as leather shoes and automobiles and raise import tariffs on Brazilian products, all unrelated to computor software unless Brazil concedes on the software issue. At first Brazil resisted, but finally gave in to the U.S. demands and enacted a new law on computer software copyrights. Had the U.S.

actually implemented these types of import restrictions and raised of tariff rates against Brazil based on the software copyright issue, the U.S. action would clearly be in violation of GATT. But, because the Brazilian government did not want to risk loosing the U.S. market for its industries, it decided to give in.

Third, Korea's net indebtedness to foreign countries exceeded 50% of its GNP at its peak time (1984-1985). It still probably exceeds 30% of Korean GNP. Between 1981 and 1983, after the second oil crisis, and especially in 1982, when Mexico's debt problem became acute, Korea experienced considerable difficulties in rolling over foreign borrowing. Consequently, it is quite understandable that the Korean government has tried to reduce its foreign indebtedness at a fairly high pace, while its balance of payments on current account is favorable as it has been in the last two years or so --- for the first time since the founding of the country. The U.S. government considers, however, that one of the "causes" of the U.S. current account deficit is the undervalued currencies of Asian NIES, including the Korean won. The U.S. government has been strongly requesting that the Korean government appreciate its currency.

As explained in the previous section, while U.S. current account balance deficits have been quite large in recent years, its net international investment position is probably positive, and ever if it is negative the level of U.S. indebtedness to foreign countries is still at a very low level relative to GNP. The U.S. indebtedness will be much lower than the present Korean level, even if the present level of U.S. current account deficits relative to GNP continues for another five or even ten years.

It is not advisable ---I would even say it is unfair--- to demand that such a small country as Korea (Korea's GNP is less than 1/45th that of the U.S.), which very recently experienced much difficulty in refinancing its debt, to refrain from lowering the level of its foreign indebtedness simply in order to improve the United States' own current account imbalance. Because Korea is heavily dependent on the U.S. both militarily and economicly, however, Korea seems to have no choice but to comply to some extent with the U.S. request to appreciate its currency.

The strong bargaining position of the U.S. government in bilateral international economic relations, as we have seen in these examples, is based upon three factors in my opinion : (1) On a purely economic level, the U.S. possesses a large domestic market for imports and well developed financial markets. Foreign countries do not want to be even partially excluded from them. (2) There are a relatively large number of cases in which the U.S. has undertaken economic sanctions against a country on economic, poilitical, or military grounds. (3) The U.S. has overwhelming political and military superiority as implied in the word "Pax Americana." These three conditions are not expected to change in near future.

<u>Responsibility for the Threat of a Systemic Crisis</u>

The threat of a systemic crisis to the world trading system with GATT and the IMF at its center is not caused by the current account imbalance between Japan and the U.S., which are the two largest economies in the system. Nor is it caused by the relative decline in importance or the status of the U.S. which has been the leading member of the system, nor by worsened economic conditions in the U.S. Although the relative decline of the weight of the U.S. in the system may be the indirect causes of the threat, it does not in itself disturb the harmonious functioning, growth, and prosperity of the world trading system. The main factor that threatens and leads to a "systemic crisis" is U.S. protectionism and politicization of the trade issues, which are based on misperceptions and misunderstandings --- or attempts to exploit misunderstandings --- about U.S. current account (or trade) deficits.

I want to stress, however, that the above should not be construed as asserting that the world trading system is in danger because the U.S. is behaving "badly" or that it is the U.S. that is "at fault".

I would like to emphasize that what I have offered thus far is essentially an objective analysis of facts and some proposals to improve the current situations. I have not discussed who are the "good guys" and the "bad guys", nor have I said who is "responsible" for the difficulties the world trading system is now encountering, and who is not.

Who are the "good guys" and who are the "bad guys" cannot be discussed without premises including strong value judgements. Even among economists, there are quite a few who express strong condemnations and judgements about good guys and bad guys, but I do not think there is much to be gained from such discussions. Moreover, when people say who or which countries are "responsible" for certain outcomes, what kind of "responsibility" are they talking about? Is it moral responsibility, political responsibility, or legal responsibility? Of these responsibilities, or "goods" or "bads", the only one that can be discussed more or less objectively is legal responsibility. Thus, for the problems of international economic affairs such as those dealt with here, responsibility would refer only to the objective criterion of responsibility under international law. Other kinds of discussions of responsibility or discussions of "goods" and "bads" cannot be carried out without clearly setting premises which belong to the domain of ethics or religion. Without making clear the criteria according to which the judgement is made, the discussion will be unscientific and have no relation to economics as a science.

For what have already occurred, discussions of responsibility, or "goods" and "bads" are not very useful. We should discuss what kinds of actions from the present time into the future are possible or desireable. In the next section, I would like to discuss from Japan's perspective what things are possible and desireable in order to avoid a systemic crisis of the international trading system.

V. Concluding Remarks: The Future of the World Trading System and Japan's Role

As discussed in the previous sections, a "threat of a systemic crisis" of the world trading system now appears to be emerging. If this threat develops into a real crisis, it will bring about great losses to the most countries participating in the world trading system, especially countries that are heavily dependent on international trade.

Although GATT has been subject to some serious erosions in recent years, the fundamental rules of GATT are based upon a high degree of economic rationality. In the on-going Uruguay Round, member countries, including the U.S., have proposed a number of important issues to be included in the agenda. Yet no proposal has been made which tries to modify the basic principles of GATT. Although no country is satisfied with all the aspects of the current world trading arrangements, apparently the best choice for all nations is to cooperate in developing the system and working to improve upon its weaknesses.

As discussed in the third section, it is unlikely that the current international monetary system can be changed greatly. The most advisable course for all countries that actively participate in the world trading and currency systems is that of support and defense of the current system and of working together for their stable growth and gradual improvement and development.

<u>Request for Self-Restraint by the U.S.</u>

What is by far most necessary in order to alleviate the threat of a "systemic crisis" is self-restraint on the part of the U.S., particularly the self-restraint of politicians and high ranking officials in the U.S. Congress, Administration, and U.S. Trade Representative (USTR).

The economic benefits that the U.S. receives from the world trading system are enormous. The political gains accrued to the U.S. as the foremost leader of the world trading system are immesurable. The idea that the U.S. is now suffering from losses by participating in the world trading system and from international economic relations is entirely wrong. The U.S. is among the countries that gain the most from present arrangements. Reducing the efficiency and ability of the system to work or disturbing and upsetting the system can only be detrimental to the national interest of the U.S. The U.S. will benefit most by faithfully observing its duties as a member country of GATT and by assuming a leadership role in the stable development of the world trading system.

Some U.S. economists have told me that they fundamentally agree with my evaluation of the current U.S. economic condition and economic analyses of the causes of U.S. trade deficits and with the measures I propose for overcoming present difficulties (cf. Section III of this paper). They say that U.S. politicians, however, will never agree with these economic arguments. If such is the case, then the threat of a "systemic crisis" comes from the failure of American economists to persuade and educate their politicians and opinion leaders. Thus, the situation should be called a "education failure". Major industrialized countries should unite in requesting that the U.S. obey its duties as a member country of GATT and IMF. If the U.S. intends to reduce its current account or trade deficit, then the U.S. itself ought to implement effective macroeconomic measures for that purpose.

Japan's International Economic Relations and It's Political Economy

Since the 1950's the rate of growth of industrial productivity in Japan has been extremely high, and Japan's relative importance in the international economic community has risen quickly. In a short period of time Japan moved from being a triflingly small county to being the number 2 economic power in the world trading system (see Table 2). Japan is one of the countries that has gained the most from the world trading system, and she will continue to do so. Clearly, without current world trade arrangements, Japan's economic growth could not have occurred and would probably cease to occur.

If the world trading system were to break down or disintegrate as a result of "a systemic crisis", Japan, which is an island country and neither is nor will be able to belong to any particular regional bloc, would suffer far more than the U.S. and the West European countries. This is because the U.S. and all of the West European countries are either continental countries or have close relationships with continental countries within the EC.

The Japanese economy has been developing very rapidly since the 1950's. As a result, Japan has not been able to keep pace in adjusting itself to the new situation. In terms of domestic economic configurations, institutional arrangements regarding international economic relations, people's perceptions, and social customs Japan has not caught up with its changing status in the world economy. As far as international economic relations are concerned, Japan's ability to negotiate is not yet at a level commensurate with its new status in the world trading system. Neither is Japan's voice to present its opinions in the international economic community commensurate with its relative economic size, or with the percentage of funds it supplies for world economic development : for example, the size of Japan's quotas in the IMF and IBRD are still behind those of Britain and France, not to speak of West Germany.

In the last 20 years or so, the Japanese government has made strenuous efforts to lower trade barriers, increase the openness of its domestic markets, and make domestic economic institutions harmonious with liberal and multilateral international economic relations. In the last 10 years, these efforts have been accelerated. However, the residues of numerous protectionist regulations in the past still remain. These are left over from older times when Japan was economically weak and small. It cannot be denied that these regulations tend to constitute tangible and intangible barriers to the healthy development of Japan's international economic relations.

In Japan, an important problem in this regard is that the degree of transparency of·market place rules and regulations is rather low. There are cases where the details of rules and regulations are not clear nor are they easy to understand even for us Japanese economists. It is urgent that, in addition to renovating rules and regulations so that they are harmonious with liberal and multilateral international economic relations, such rules and regulations be made as transparent as possible to promote international understanding.

The Problem of Agricultural Imports

One event that demonstrates how perceptions of the Japanese government and people are lagging behind the rapid economic progress that has taken place in Japan over the past forty years is a ruling by a GATT panel in 1987 that Japan's restrictions on agricultural imports are in violation of GATT articles. Japan has enjoyed enormous benefits from the present world trading system and must now play a leadership role as the world's second largest economic power. Nevertheless, Japan has allowed itself to be found in violation of GATT rules.

Here I would like to present my view on the liberalization of agricultual trade in Japan. In 1956 forty percent of Japan's population was engaged in agriculture. Today that percentage has fallen to a meager 6 to 7 percent, the majority of which are elderly people over 50 years in age. However, a great proportion of the voting public has some connection to agriculture. In fact, a majority of urban residents were either born in rural communities, are only one generation removed from farming families, or have relatives in rural communities. Thus, a great many people are strongly sympathetic to farmers. Furthermore, policymakers who are responsible for Japan's current agricultural policies still have vivid memories of severe food shortages and the hunger during and after World War II from which they greatly suffered for many years.

Japanese agriculture and agricultural communities have undergone great economic and social changes over the past 30 years. In the process, both farming and non-farming populations have become much richer and more conservative. Now neither of these populations desire further changes in either agriculture or rural communities.

The strong political support for agricultural protectionism in Japan stems from both historical experience and current political conditions. It is not only the rural-based Liberal Democratic Party that opposes the liberalization of agricultural imports : the opposition parties, although they draw most of their support from urban areas, are even more strongly opposed to liberalization.

Trade in agricultural products is quite different from that in other goods or manufactures in that long-run price elasticity of supply is extremely high, whereas short-run elasticity is very low. At the time of short-run supply shortages and consequent supply and demand imbalances, the elasticity of export supply is nearly zero until the next harvest somewhere in the world. Importing countries are thus unable to obtain urgently needed supplies. In 1973, when the U.S. laid an embargo on the export of soybeans because of rising domestic feed grain prices, even soybeans that had been already contracted and waiting at piers for loading in ports were not loaded onto ships. The Japanese were forced to realize this peculiar aspect of agricultural trade through a rather rude and bitter awakening.

Japan is now by far the world's largest importer of foodstuffs, domesticly producing only 30 percent of its grain consumption. There are no other countries with a self-sufficiency ratio as low as Japan, at least among countries with a fairly large population. Japan's attempt to maintain a minimum level of domestic supply in foodstuffs is similar to the United States' attempt in recent years to achieve self-sufficiency in energy supply. Even from a purely economic viewpoint such a policy is not necessarily irrational. With the above points in mind, it is easy to understand why a complete and unconditional laissez-faire policy on Japan's agricultural imports is not advisable.

On the other hand, the desire to shield domestic producers from the impact of international competition which would result from liberalization of whatever agricultural imports cannot be a valid reason to justify the continuation of import restrictions on a permanent basis. This is especially so, in the case of agricultural products which have no value or only a limited value as essential foodstuffs. If other countries used similar reasons to justify quantitative import restrictions, the GATT system would collapse. One of the methods of maintaining security in the supply of foodstuffs to overcome a possible supply crisis would be to insure that domestic production remains above a certain level. This goal could be achieved, for example, by establishing a system such as a deficiency payment system for producers. Japan would thus be able to preserve at least a minimum domestic supply capacity without infringing upon the GATT rules. It would also be desirable to establish a stockpiling scheme, such as the one which has long been practiced by Switzerland or Sweden, to insure a supply of a number of essential foodstuffs.

There are a number of aspects of the current GATT regulations regarding agriculture that are in need of revision. Examples are the lack of consideration given to countries with a high degree of import dependence, or the toleration of agricultural export subsidies.[11] While the Japanese government should reform its food and agricultural policies to conform with GATT articles, it is obvious that there are also needs to improve agriculture-related articles.

<u>The Outlook for Japan-U.S. Trade "Friction"</u>

Will the present threat of a "systemic crisis" of the world trading system develop into a full-blown crisis? Or will the threat of crisis gradually subside? On this point I venture to say that I prefer to be relatively optimistic.

There have been recent signs of a cooling off of protectionist sentiment in the U.S., perhaps as countervailing powers have worked to restrain more extreme protectionism. Japan's current account surplus, which some (or perhaps most) Americans, and even some non-Americans including Japanese, have mistakenly regarded as the "root of all evil", has recently been declining quite remarkably, after following strong J-curve effects stemming from the sharp appreciations of the yen since Fall 1985. Japan's current account surplus as a percentage of GNP, after peaking at 4.9 percent in the second quarter of 1987, fell rapidly to 3.3 - 3.6 percent in the latter half of 1987. This figure will likely fall below 3.0 percent in 1988. I consider the basic causes of the U.S. current account deficit to be its excessive aggregate domestic demand, caused by large budget deficit and a low level of private savings. Policymakers, intellectuals, and opinion leaders in the U.S. are now gradually coming to recognize that in order to solve the "U.S. trade problem" it is definitely necessary to improve the macroeconomic performance of the U.S. economy, especially with regard to the above points.

While imbalances in international payments between major industrialized countries will not disappear in the near future, and cases of friction in trade and other international economic affairs will continue to occur frequently, hopefully the probability that these imbalances and cases of friction will trigger a "systemic crisis" is gradually decreasing.

The Future of the World Trading System

As discussed in the previous section, one of the background conditions that has given rise to the "threat of a systemic crisis" is Japan's challenge to the once overwhelming predominance of the U.S. economy and its industries. The U.S.-Japan relationship cannot be understood, however, in terms of a relationship between a "hegemon" nation and a "challenger" nation. In this respect the U.S.-Japan relationship is entirely different from the relationship that once prevailed between the U.S. and Britain, or going further back in history, the relationship between the Netherlands, Spain, and Britain. Japan's challenge to U.S. predominance is limited to only certain "economic" areas, such as productivity and technology in a limited number of industries. In other areas Japan is in no position to challenge the U.S. Japan lags begind the U.S. not only in military and political power, but also in basic science and research, and in academic learning in general. In fact, in these fields Japan relies heavily upon the U.S..

Japan is an island trading nation, and as was revealed at the time of the oil crises or the U.S. embargo on soybean exports, Japan is more vulnerable even in a purely economic sense than a continental country like the U.S., the Soviet Union or China. Britain was able to achieve global hegemony as an island nation, because it had a strong navy and control of the seas. Such power enabled Britain to maintain an empire with colonies all over the world. In the case of Japan, such an option is simply out of the question today.

There is a view that the current world trading system has up to now been supported by what is called the "Pax Americana", and that because the "economic power" of the U.S. has "declined", it is no longer able to support the Pax Americana system. It is feared that the system is nearing its end and that cases of friction and disruption will increase, leading eventually to a "systemic crisis". This view, however, is fundamentally mistaken on a number of points.

While the U.S. has maintained its overwhelmingly superior political and military position relative to other countries of the Western alliance, and the U.S. continues to exercise leadership in these areas, this has not always been the case regarding arrangements in economic areas, especially with regard to the world trading system centered around GATT and the IMF. GATT as well as the IMF are based upon multilateral economic agreements, and while the U.S. has had a great deal of influence and leadership in them, other major countries also have played important roles in the creation and development of such agreements. This point can easily be seen through the history of protracted multilateral negotiations over the major revisions and improvements of the system---the Kennedy Round, the Tokyo Round, and the introduction of the Generalized Scheme of Preferences in the case of GATT, and the creation of Special Drawing Rights and the Second Revision in the case of the IMF. Moreover, as mentioned previously, there is an anomaly in the U.S. relationship to GATT. That anomoly has been a handicap for the U.S. in playing a leadership role in GATT. These points attest to the fact that global arrangements in economic areas cannot be said to be a part of what is said to be the "Pax Americana" regime. The GATT and IMF systems were created and developed by a series of collective decisions and multilateral negotiations among major powers. Certainly the United States has not been the sole creator and supports of the world trading system. It is also not accurate to say that the decline in U.S economic power has made maintenance of the system more difficult. As discussed in Section III, the U.S. economy has not been weakened much in recent years. It is unlikely that the U.S. dollar will lose its key currency position in the foreseeable future. The United States' strong bargaining power in bilateral economic relations has not been weakened recently, as discussed in Section IV.

The world trading system has developed through multilateral cooperation and collective decision-making among the major Western powers, although the influence of each of them has been changing over time. Japan did not participate in the creation of the system, and its influence was very small as late as in the 1970's, but Japan is now becoming the "number two" country in the system. It is clear that the U.S. will continue to be the "number one" leader of the system in the future.

In today's world one should not, of course, ignore the existence and influence of the Soviet Union and the Eastern Bloc around it, as well as the influence of developing nations of the Third World. East-West tensions occasionally increase and the conflict of interests between the North and South occasionally flares up.[12)] In this environment, it is important to recognize that the common interests of the U.S., Europe, and Japan, particularly those of the U.S. and Japan, by far outweigh conflicts of economic interests among them, most of which are temporary and can be resolved if the parties concerned behave rationally and deliberately.

With this in mind, I believe that, in spite of the friction in various U.S.-Japan trade issues, and the rise of tension due to prolonged negotiation in order to resolve such cases, differences are not as important as the fundamental common interests and cooperative relationship that these two countries enjoy.

FOOTNOTES

* This is a revised, English version of a paper presented at a conference on "Globalized Business Activity and the World Economy", sponsored by MITI/RI and held in Tokyo in June 1988. A Japanese version was published in (1) R. Komiya and MITI/RI (eds.), Kokusaika-suru Kigyo to Sekai-Keizai (Globalized Business Activity and the World Economy), Tokyo : Toyo-Keizai Shimposha, 1989 and a longer one in (2) R. Komiya, Gendai Nihon-Keizai : Makuro-teki Tenkai to Kokusai Keizai Kankei (The Contemporary Japanese Economy : Its Macroeconomic Denelopment), Tokyo : The University of Tokyo Press, 1988.

1. The U.S. in the latter part of the 1940s and the first half of the 1950s strongly supported Japan's accession to GATT. Although the West European nations opposed Japan's accession, the U.S., wishing the stabilization and economic development of Japan and to lessen it burden of aid to Japan, carried out bilateral tariff negotiations with Japan, overcame Western European objections, and achieved its aim of Japanese membership in GATT. When one considers this early postwar history on the one hand and the Japan-U.S. trade confrontation today on the other, one is struck with a sense of irony. A number of West European countries applied Article 35 of the GATT to Japan at the time of the latter's accession to Gatt, which means excluding Japan from most-favored-nation (MFN) treatment within GATT. Moreover, many of the countries that joined GATT after Japan, especially newly independent British and French ex-colonies, applied Article 35 to Japan. Therefore, Japan was formally a member of GATT, but its status was an anomaly since it had formal GATT (MFN) relations with only a handful of major trading nations (notably the U.S.), until around 1970. Furthermore, even after a number of West European countries formally withdrew the application of Article 35 to Japan, many of them discriminated against Japan illegally. Some of these countries do so even today.

2. There might be undesirable effects on a country's trade and industrial structure resulting from wide fluctuations in exchange rates under the floating exchange rate system, or from large undervaluations or overvaluations of a country's currency over an extended period, such as the overvaluation of the U.S. dollar between 1980-1985. One method of avoiding these effects is the "import-export link system" proposed by the author. See Ryutaro Komiya, "U.S.-Japan Trade Friction and International Cooperation" (in Japanese), Toyo Keizai, June 7 and 14, 1986, issues.

3. See Section IV for further discussion on this point.

4. In this type of discussion, foreign investment and indebtedness usually include not only credit and debt, but also direct investment and portfolio equity investment, so that the terms "net creditor country" or "net debtor country" are not accurate; the net external investment position including direct investment and portfolio equity investment is a more appropriate basic indicator.

5. An example of simple calculation on this point is as follows ;
when it is assumed that
(a) the U.S. net external investment position at present is zero, that
(b) the price level is stable and the terms of trade are also constant, that
(c) the ratio of the U.S. current account deficit to the GNP of the U.S. continues to be zero for this period, and that
(d) the growth rate of the U.S. GNP (real) is zero during this period, then
the ratio of the U.S. net external debt to its GNP will be just 30% ten years later.

Assuming that
(d') (real) GNP growth rate will continue to be 2% for a decade, instead of 0%

in (d), the ratio of net external debt ten years after will be 27.5%, instead of 30%.

If the ratio of current account deficit excluding returns from foreign investments and interest payments to the GNP of the U.S. is 3% every year, instead of (c'), and if the real interest rate is 3%, under the assumption (d'), then the ratio of net external debt will be 31.4% ten years after. In this case annual interest payment burden will be about 0.9% of the GNP. If the real interest rate is 4% in this case, these figures will be 32.8% and 1.3% respectively.

6. This point is in principle similar to the concern that some people in international institutions made a great fuss about at the time of the first oil crisis : namely the so-called "oil money" would not easily be recycled back to international financial markets. As a matter of fact "oil money" was automatically recycled back to the Eurodollar market. If the oil crisis had occurred under the gold standard (or the gold exchange standard) the oil importing nations as a whole would have had to hand over an enormous amount of gold to the OPEC countries. However, under the floating exchange rate system, the OPEC low absorber countries all had to purchase financial instruments (denominated mostly in dollars, and partly in British pounds at the beginning) in international financial markets in an amount exactly equal to their current account surpluses.

7. This argument is based on the "assignment" argument of economic policy in an international economy.

8. The percentage of imports to GNP in the U.S. was around 3% in 1960, but grew quite rapidly in the 1970s and has reached around 10% today. Furthermore, imports of items that are conspicuous to average citizens, such as automobiles and consumer durables, have grown especially rapidly.

9. The correct understanding of these problems has been explained in Section III.

10. I would like to add two points to the discussion of where the U.S. differs from some other countries including Japan. First, in the Japanese and British parliamentary system the Cabinet must be supported by the majority of the legislature (Diet or Parliament) in order to continue in office, whereas in the U.S. presidential system, major policy disagreements between the Administration and the legislature can exist and continue indefinitely.

Second, under Japan's Constitution, international treaties ratified by the Diet take legal precedence over laws legislated by the Diet, so that the Diet cannot enact a domestic law that violates international treaties already ratified. In the U.S., on the other hand, treaties ratified by the Senate and domestic laws have the same legal status, so that the most recently rafitied treaties or laws take legal precedence over prior treaties and laws. Thus, if a law is passed that conflicts with a previously ratified treaty, the more recent law takes precedence. In this way the U.S. Congress can unilaterally alter or even withdraw from international treaties without the consent of its foreign partners, as far as the domestic legal status of the treaty is concerned. However, the U.S. Congress would be cautious and prudent in legislating domestic laws that conflict with international treaties that have been previously ratified. In the case of GATT, the serious problem from a foreigners' point of view is that the U.S. Congress does not even consider GATT as constituting "existing law."

11. For this reason, when Switzerland joined GATT it asked for and was given a waiver of import restrictions on agricultural products.

12. Japan can play an important role in North-South relations due to its

special position among the Western industrialized nations. In fact, Japan has steadily expanded its role in North-South relations in recent years. Just a short while ago Japan was a developing country. In the 1950's and 60's, for example, Japan went through the experience of borrowing from the World Bank. This past experience puts Japan in a special position to understand problems in the South countries, and to make special contributions to North-South cooperation.

TABLES

Table 1 Trade Dependence of Major Economies[a)] : 1962-1985 (Unit : %)

	Japan	U. S.	U. K.	F.R.G.	France	E. C.	China
1962	17.9	7.1	30.2	28.4	16.4	30.5	8.8
1970	18.8	8.7	33.5	34.8	20.2	36.6	5.9
1980	26.1	18.5	42.2	46.7	38.3	48.9	15.5
1985	22.5	14.7	44.3	51.3	39.9	51.7	21.9

a) Ratio of imports and exports to GNP.
Source : IMF, International Financial Statistics : World Bank (IBRD), World Bank Atlas

Table 2 Cases of Extended Current Account Deficits[a)]

Country		Period
New Zealand	5. 1%	1970~87
Denmark	3. 1%	1970~87
Greece	5. 0%	1970~87
Iceland	3. 8%	1970~87
Australia	3. 3%	1970~87
Norway	5. 5%	1970~79
Finland	3. 8%	1972~76
Turkey	3. 3%	1974~87
Portugal	5. 7%	1974~84

a) Examples of countries who had an average ratio current account deficit to GNP exceeding 3% for at least 5 years.
Source : OECD, Economic Outlook

Table 3 U.S. Bilateral Trade Balance : 1970-1987

(Unit : 100 million U.S. Dollars)

	1970	1975	1980	1981	1982	1983	1984	1985	1986	thru9/1987
World	33	42	▲362	▲396	▲426	▲693	▲1233	▲1485	▲1698	▲1282
Japan	▲ 12	▲ 28	▲122	▲181	▲190	▲217	▲368	▲497	▲586	▲443
Canada	▲ 20	▲ 10	▲ 66	▲ 73	▲131	▲143	▲204	▲222	▲233	▲ 85
EC	18	50	157	87	35	▲ 15	▲133	▲226	▲264	▲176
Korea	3	2	3	▲ 4	▲ 5	▲ 17	▲ 40	▲ 48	▲ 71	▲ 74
Taiwan	0	▲ 5	▲ 30	▲ 43	▲ 52	▲ 74	▲111	▲131	▲157	▲149
Hong Kong	▲ 5	▲ 9	▲ 23	▲ 31	▲ 34	▲ 43	▲ 58	▲ 62	▲ 64	▲ 49
The 6 ASEAN	0	▲ 15	▲ 40	▲ 55	▲ 21	▲ 42	▲ 72	▲ 75	▲ 66	▲ 63
Cen/So America	9	31	47	54	▲ 38	▲147	▲180	▲176	▲136	▲112
Mexico	37	35	23	38	▲ 40	▲ 79	▲ 63	▲ 58	▲ 52	▲ 45
Brazil	2	0	3	▲ 11	▲ 12	▲ 28	▲ 56	▲ 50	▲ 35	▲ 31

Source : U.S. Commerce Dept., "Highlights of US Export and Import Trade"

Table 4 U.S. Foreign Investment Position, Receipts and Payments of Investment Incomes and Technologies and Other Royalties : 1970-1987

	Total Assets	Total Debt	Difference	Investment Incomes			Royalties on Technologies e.t.c.		
				Receipts	Payments	Balance	Receipts	Payments	Balance
1970	165.5	106.8	58.6	11,409	5,167	6,242	600	119	481
1975	295.1	221.2	73.9	17,875	11,845	6,030	4,223	443	3,780
1980	607.1	500.8	106.3	75,936	43,174	32,762	6,865	769	6,096
1981	719.8	578.7	141.1	85,945	52,908	33,037	7,253	693	6,560
1982	824.9	688.0	137.0	84,146	56,842	27,304	7,139	337	6,802
1983	873.9	784.3	89.6	77,003	53,495	23,508	7,854	452	7,402
1984	896.1	892.5	3.6	87,609	68,500	19,109	8,115	516	7,599
1985	949.4	1061.3	▲ 111.9	89,991	64,803	25,188	5,823	847	4,976
1986	1067.9	1331.5	▲ 263.6	88,209	67,365	20,844	6,862	1,077	5,785
1987 (Provisional)	n.a.	n.a.	n.a.	99,772	85,288	14,484	8,101	1,220	6,881
	Unit : billion dollars			Unit : million Dollars			Unit : million dollars		

(Source) Total assets and total debt figures are from The Economic Report of the President
The balance of investment returns and technological balance of payments figures are from the Survey of Current Business

Table 5 Ratio of U.S. Capital Formation to GNP[a)]

(Unit：%)

	A Gross Domestic Capital Formation	B Depreciation Allowances and Other Capital Consumption	C Net Domestic Capital Formation (C=A-B)	D Current Account Surplus (or Deficit ▲)	E U.S. Net Asset Increase (E=C+D)
1970	14.6	8.7	5.9 (22.3)	0.2	6.1 (23.6)
1975	13.7	10.1	3.6 (19.6)	1.1	4.7 (19.7)
1980	16.0	11.1	4.9 (18.8)	0.1	4.9 (17.9)
1981	16.9	11.4	5.5 (17.5)	0.2	5.7 (18.3)
1982	14.1	12.1	2.0 (16.2)	▲ 0.3	1.7 (17.0)
1983	14.7	11.6	3.1 (14.6)	▲ 1.4	1.7 (16.3)
1984	17.6	11.0	6.6 (14.2)	▲ 2.8	3.6 (17.0)
1985	16.7	10.9	5.1 (14.0)	▲ 2.9	2.1 (17.4)
1986	15.8	10.8	5.1 (13.6)	▲ 3.3	1.7 (17.7)

a) Figures in parenthesis in columns C and E are Japan's ratios, for reference.
Source : Economic Report of The President

Table 6 Increase in Imports of manufactured Products to Japan (percent increase over the previous year)

(Unit : %)

	U. S.	E. C.	Asian NIES	Korea	Taiwan	ASEAN	Total
1986	23.9	59.7	37.2	39.4	33.8	12.6	31.4
1987	0.2	26.7	56.0	63.0	62.6	47.8	25.0

Source : The Japanese Ministry of Finance, Gaikoku Boeki Gaikyo (Foreign Trade Summary).