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THE U.S.-JAPAN TRADE PROBLEM:
AN ECONOMIC ANALYSIS FROM A JAPANESE VIEWPOINT

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ABSTRACT

There are several misunderstandings underlying the debate on U.S.-Japan trade problems. In the light of the standard economic theory as well as historical and contemporary experience of various countries, the present level of the U.S. trade deficit should not in itself be a cause for serious concern. Also, it is a mistake to blame Japan for its trade surplus. What the U.S. should be concerned about is not so much the trade deficit in itself, as the extremely low savings rate for the entire economy. The fundamental causes of the U.S. trade deficit are macroeconomic factors in the U.S. economy, in particular the massive government deficit and the low savings rate in the private sector. The bilateral trade imbalance between the U.S. and Japan is the result of the respective countries' overall trade imbalance, not the cause of the latter. If the U.S. deems it necessary or desirable to improve the trade deficit in the medium- to long-run, the U.S. itself should endeavor to curb its domestic demand, raise its savings rate and expand productive capacity through improved productivity. Over the medium- and long-terms, tariff and non-tariff barriers of the U.S. trade partners, which many U.S. politicians and citizens seem to consider to be the cause of the U.S. trade deficit, have virtually no effect on the current account of the countries concerned.

Japan today is one of the most "open" countries among OECD members, with lower levels of both tariff and non-tariff barriers than most others. The claim that Japan's market is closed is an unfounded "myth" based upon misunderstandings.

There are the legal, economic, and political flaws in the "Section 301 Approach", which seeks to improve U.S. trade balance by requesting the U.S. trade partners to lower their "non-tariff barriers" (NTBs) through vigorous negotiations under the threat of unilateral sanctions. Even if the U.S. succeeds in removing what it alleges to be Japan's NTBs by the Section 301 Approach, that will have virtually no effect of improving the U.S. trade deficit.

For both the U.S. and Japan, there is only a very small area in which their economic interests are in conflict, whereas the areas in which they have common interests are by far larger. The U.S. should stop placing emphasis on negotiations that politicize bilateral trade problems with Japan and needlessly exacerbate frictions. Instead the U.S. and Japan should cooperate towards strengthening the global free-trade system by jointly seeking the success of the Uruguay Round.

THE U.S.-JAPAN TRADE PROBLEM:
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by

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INTRODUCTION

Against the backdrop of the United States's persistent trade deficits and Japan's surpluses, U.S.-Japan trade and other economic relations have been steadily aggravating, and the U.S. trade policy to rectify the "unfair trade practices," as symbolized by Section 301 and related sections of the Omnibus Trade Act of 1988, have developed into interminable debate surrounding Japan's supposed "nontariff barriers to trade." This debate has been launched, however, on the basis of misunderstandings in our view. It gives an impression that most of those engaged in the debate have been trapped in a labyrinthine blind alley.

The purpose of this paper is to point out the deep-rooted misunderstandings underlying the debate on the U.S.-Japan trade problem, to elucidate them in the light of the standard economic theory and recognized facts, and thereby to demonstrate how mistaken they are. In Section I we cast light on the misunderstandings concerning the seriousness of the U.S. trade deficit and its causes, and contrast these misunderstandings with the correct understanding of the problem from the perspective of macroeconomic theory. In Section II we examine critically various arguments about Japan's "nontariff barriers" that are put forward to verify the "closedness" of the Japanese market. Then in Section III we point out the flaws in the thinking behind Section 301 and the related provisions of the U.S. Omnibus Trade Act of 1988, which seeks to eliminate or lower these "nontariff barriers" of the trade partners through vigorous negotiations under the threat of unilateral sanctions by the U.S. Finally, we summarize the main conclusions of the paper, and indicate the direction in which the United States and Japan should proceed.

I A MACROECONOMIC PERSPECTIVE OF U.S.-JAPAN TRADE RELATIONS

1. U.S.-Japan trade relations in the postwar era

In considering current problems in the U.S.-Japan trade relations, we first examine the history of U.S.-Japan "trade friction" that have occurred in the postwar era. From around 1955 to the mid-1960s, when there was a sharp increase in Japan's export of textiles, sundry goods, sewing machines and several other items to the United States, the Japanese government was frequently requested by the U.S. government to impose voluntary export restraints (VER), and it readily met these requests. At that time there was no such phrase as "trade friction", since the trade issue did not turn into a politicized issue. Subsequently, however, there were two waves of "trade friction" between Japan and the United States. The first wave occurred in 1968-72, at the time of the prolonged and stormy U.S.-Japan textile negotiations, and the second wave rose in 1976-78, at the time of the global recession in the wake of the first oil crisis, when Japan sustained an economic recovery through an "export drive", a phenomenon characteristic of the Japanese economy in the depression. Both of these waves subsided when each of the two oil crises caused Japan's balance of payments on current account to plunge deeply into deficit. Coming into the 1980s, however, a third wave was initiated in 1980 as a result of a sharp increase in Japanese automobile exports, when Japan was still running a current account deficit and the United States a surplus. From 1983, trade friction grew steadily more acute year by year, as the United States's current account fell deeply into deficit, while Japan's generated massive surpluses. This chronicity of U.S.-Japan "trade friction" in the 1980s has created a threat to the stability of the worldwide free trade system ¹⁾.

On the side of Japanese exports, the focus of the trade friction has gradually shifted from the initial one of textiles, sundry goods and other light industry products, to industrial fields requiring medium-level technologies and then those requiring high technologies, including steel, color televisions, automobiles, machine tools, and semiconductors. On the import side, trade friction began around 1976. It was initially confined to relatively distinct and limited problems such as import of beef, oranges, tobacco, and metal baseball bats, and the procurement policy of the Nippon Telegraph and Telephone Corporation, but steadily spread to broader and more complex problems that defy easy resolution, such as rice import, Japan's domestic distribution system, the so-called "keiretsu links" among corporations, the FSX fighter, and tendering for public construction projects.

From the 1960s to the beginning of the 1980s, in most years both the surpluses and deficits of the United States's current account fluctuated within about 1 percent of its GNP, while Japan's surpluses and deficits did within 2 percent. But from 1983 to 1985, the U.S. deficits topped the 3 percent level, and nevertheless the U.S. dollar soared in value against the currencies of all other countries: this was the period of unusual dollar strength. The dollar's strength underwent a substantial adjustment from September 1985 onwards, however, and within the next two years the yen appreciated by nearly 100 percent against the U.S. dollar. This weakening of the dollar and corresponding unprecedented sharp strengthening of the yen, together with the reduction of the U.S. budget deficit (from a peak of 6.3 percent of GNP in fiscal 1983, to an estimated 2.2 percent in fiscal 1990) and the expansion of domestic demand in Japan, brought about a substantial adjustment in the overall current account imbalance of the United States and Japan. With the J-curve effect at work the United States's current account deficit

reached 3.9 percent of GNP (1987 third quarter), and Japan's surplus reached 4.9 percent (1986 fourth quarter) at the peak, but in both countries these figures have now dropped to around 2 percent (see Table 1).

One might expect that the adjustment of the imbalance both of the U.S. and Japan would lead to a calming down of the U.S.-Japan trade friction, but that has not been the case. The U.S.-Japan trade problems have been more and more politicized in U.S., in spite of the declining imbalance.

2. Misunderstandings concerning the U.S. trade deficit

As described above, U.S.-Japan trade friction persists to this day, having passed through several stages over a long period. In our view the "Japan-bashing" and the unilateral demands and actions of the U.S. government vis-a-vis Japan and other surplus countries are based upon the following mistaken popular perceptions about the trade deficit (including both merchandise and service trade)²⁾.

- 1) The present large trade deficit and the concomitant massive inflow of capital is something "very bad" for the United States.
- 2) The cause of the overall U.S. trade deficit lies in its bilateral trade deficits with individual trading partners, and the large deficit with Japan in particular.
- 3) The primary cause of the United States's large trade deficit with Japan is Japan's high nontariff barriers, and that if these are prized up open using the Omnibus Trade Act as a crowbar, The United States's trade deficit will be eliminated or greatly reduced.

In sum, these beliefs hold that a "very bad thing" is happening to the United States, and the culprit is Japan.

Since World War II, however, many countries have fallen into balance of payments difficulties, and have overcome them. On the causes of balance of payments deficits and the economic policy measures to deal with them, there are already

the standard economic theory of the balance of payments deficit and a standard menu of policy measures to deal with payments difficulties ³⁾. If these had been properly understood by U.S. politicians and ordinary citizens, the mistaken conceptions mentioned above would not have been rampant, there would have been more appropriate understanding about the causes of the U.S. trade deficit, correct measures would have been implemented, and we would not have had the acute U.S.-Japan trade friction we have today. One of the main causes of U.S.-Japan trade friction is, then, the lack of correct economic understanding of balance of payments problems on the part of U.S. politicians and ordinary citizens.

Based on orthodox economic theory, we contend the following.

- ① The current level of the trade deficit should not in itself be the cause of great concern to the United States.
- ② The liberalization of international capital movement is one of the basic principles for today's worldwide free trade system. Japan's large trade surplus reflects the supply of capital (savings) by Japan to other countries of the world. Since many countries need capital for their economic development, Japan's surplus warrants no criticism at all. Countries that do not desire to import capital are free to improve their trade imbalances by employing standard policy measures to reduce balance of payments deficits.
- ③ The United States should be worried not so much about the trade deficit itself as about the very low level of savings for the U.S. economy as a whole.
- ④ The large bilateral trade imbalance between Japan and the United States is the result, not the cause, of the overall trade imbalance of the two nations.

- ⑤ The fundamental cause of the United States's trade deficit lie in macroeconomic factors in the U.S. economy, in particular the massive budget deficit and the low level of savings in the private sector. Unless there is an improvement in these, it is unlikely that the U.S. trade deficit is reduced.
- ⑥ Tariff and nontariff barriers and changes thereof have virtually no effect on the trade balance in the medium- and long-runs.
- ⑦ Although this is concerned with facts rather than matters related to economic theory, among OECD(Organization for Economic Cooperation and Development) countries Japan is one of the countries with the lowest levels of both tariff and nontariff barriers, except for those related to a few agricultural product. No scientific evidence has ever been provided to the contrary. The allegedly closednes of the Japanese market is a myth, based on misunderstandings.
- ⑧ There are major legal and political flaws in the thinking behind Section 301 of the U.S. Omnibus Trade Act of 1988, and these risk throwing the world free trade system into disarray. From an economic pont of view, also, even if the Section 301-type approach were to succeed in removing or lowering alleged nontariff barriers in Japan, this would be unlikely to improve the U.S. trade balance.

This section discusses ①~⑥ above from a macroeconomic viewpoint. Sections II and III discuss ⑦ and ⑧ respectively.

3. International capital movement flows and the trade balance

(1) Is trade deficit a very bad thing?

Conventional wisdom in the United States seems to have it that a continuing trade deficit is a "very bad thing", but there are many examples of countries, including the United States and Britain in the nineteenth century (see Table 2),

that have sustained long-term trade surpluses or deficits (Table 3). Those Americans who think that a trade deficit of their own country is an abnormal situation are ignorant of history and of the examples of other countries: their thinking is based on self-centered tendencies. The present level of the U.S. trade deficit is not particularly large relative to those experienced by other countries. Considering only the cases of OECD countries since 1970, there are a considerable number of countries that have sustained continuous trade deficits larger than the United States at present (Table 3). Even if there is a continuation of the United States trade deficit of the past five years, the ratio of net payments of investment incomes to foreign countries to GNP should remain at a far lower level than its present level in Canada, Australia, and other countries ⁴⁾.

(2) Free capital movement

According to balance of payments terminologies, a trade deficit (surplus) ⁵⁾ is equal to a surplus (deficit) on capital account in its broader sense, including monetary accounts. The continuation of a trade deficit (surplus) implies the continuation of import of capital into (export of capital from) the country. The OECD Code of Liberalization of Capital Movements calls for member countries to liberalize capital movement as much as possible, and under the IMF (International Monetary Fund) agreement, one of the basic objectives of the international monetary system is to facilitate the flow of goods, services, and capital between countries ⁶⁾. There exists no agreement among industrialized countries requiring that trade balance be balanced whether overall or bilaterally.

From around 1980, marked progress was made in the integration of international money and capital markets, as industrialized countries further relaxed their financial regulations and exchange-rate controls, and hence

international capital flows have become much more active than before. As a natural consequence of this, capital is now flowing at an accelerated rate from countries in which savings exceed investment to countries in which investment exceeds savings. Generally speaking, this is a desirable situation from the standpoint both of the capital-exporting country (trade surplus country) and the capital-importing country (trade deficit country).

Britain sustained a trade surplus equal to between 2 and 5 percent of GNP for over one hundred years from the beginning of the nineteenth century to World War I, exporting capital to a large number of countries, including the United States, and supported the development of the world economy (see Table 2). Japan, with its high savings rate, has recently been exporting the capital as a result of its large trade surpluses to other countries of the world, thereby contributing to world economic development. Thus to think that the persistence of Japan's trade surplus is a disturbing factor for the world economy is based upon a failure to properly evaluate the role of international capital movement.

It is sometimes asserted that Japan should reduce its trade surplus by lowering its savings rate and/or increasing public investment, which does not bring about an increase in production capacity. If Japan were to do so, however, and reduce its trade surplus, it would lead to a tightening of the world capital market, raising real interest rates further above their present levels, which are already at about the highest level in the postwar period. The effect of this would be to further exacerbate the difficulties of the heavily indebted developing countries, and to curb investment in countries outside Japan. It would not be a desirable situation for many people in many countries .

(3) Low level of savings

In our view the problem facing the United States is not so much to be found in the trade deficit as in the very low overall savings rate of the economy. The net savings rate (as a ratio of National Income, excluding depreciation; 1984-87/88 average) is 22.5 percent in Japan, 14.0 percent in West Germany, and 8.4 percent in Britain, whereas it is only 3.2 percent in the United States. This low savings rate has constrained domestic investment in the United States: the level of investment in the United States is not high in spite of large capital inflows. For example the ratio of gross private investment in plant and equipment to GNP is only some 60 per cent of the level in Japan. It is impossible for such a low-saving and low-investment economy to maintain a high rate of growth over a long-run.

Even though the savings and investment ratios are low, if this arises as the result of the free choice of the private sector entities, it means that the people desire and are content with a low rate of economic growth. From the principles of consumers' sovereignty and free enterprise perhaps there would be no need for others to intervene. However, the United States's present low overall savings rate is in large part a product of the budget deficit and low savings rate in private sector, especially the former. In a parliamentary democracy a budget deficit is the result of complex political processes, and cannot be considered as the result of rational economic choice. The United States's current tax system and corporate legal system contain biases toward depressing the national savings rate. Therefore policy issues that must be addressed urgently in the United States would be those of reducing the budget deficit, of revising the tax and other institutional biases leading to low savings and excessive consumption and housing construction, and of raising the overall savings rate for the economy.

4. Causes of trade deficits

(1) "Causes" and "results" in macroeconomics.

The problems of identifying the causes of the United States's present huge trade deficit and the factors determining the its size are problems of macroeconomics, or more specifically open-economy macroeconomics. In considering macroeconomic problems such as the balance of payments deficit, ordinary people without a training in macroeconomics tend to take up just one part of the national economy, and infers ultimate effects from the direct influence of localized changes in that area. But this often slides into a fallacy of composition. For example, the notion that if Japan lowers nontariff barriers the U.S. trade deficit will be reduced is a good example of such a fallacy of composition, as explained later.

(2) Absorption approach

The absorption approach is an elementary but at the same time powerful, macroeconomic theory of a country's trade balance.

First, the equation for macroeconomic equilibrium between the demand for and supply of goods and services for a national economy is (for simplicity the distinction between GNP and GDP is ignored here):

$$(1) \text{ GNP} + \text{Imports} = \text{Consumption} + \text{Investment} + \text{Exports}$$

"Consumption" and "Investment" here denote consumption and investment expenditures of the entire national economy, including those of the government sector. If we describe the sum of the first two items on the right-hand side of this equation as being "aggregate domestic demand," or "absorption" ⁷⁾, we arrive at the following equation.

$$(2) \text{ GNP} - \text{Absorption} = \text{Trade balance}$$

Next, if we define "savings" as the non-consumption part of the components of GNP (personal incomes, corporate incomes

plus depreciation, the government's current revenues, etc.) in both the private and government sectors:

$$\text{GNP} = \text{Consumption} + \text{Savings}$$

Substituting this for the left-hand side of equation (2) results in:

$$(3) \text{ Savings} - \text{Investment} = \text{Trade balance}$$

The trade balance, that is the difference between the value of exports and imports, is equal to the difference between GNP and absorption, and also to the difference between domestic savings and investment ⁸⁾.

The absorption approach tells us that the trade balance turns into a deficit when domestic absorption in the form of consumption, investment, and government expenditures exceeds a nation's GNP, or when domestic investment exceeds savings. Hence when a country incurs a trade deficit in a situation of almost full employment, unless domestic absorption is reduced, no quick improvement to that country's trade deficit can be expected.

(3) Macroeconomic understanding of the causes of the U.S. trade deficit

Over the past few years the U.S. economy has been in a state of almost full employment, and as absorption has exceeded the full-employment level of its GNP, the spillover of demand from the domestic supply capacity has given rise to trade deficits. The "cause" of the United States's present large trade deficit lies in the factors giving rise to domestic absorption that is larger than its supply capacity (GNP) at the full-employment level. This is the standard answer of macroeconomics about the "cause" of the U.S. trade deficit.

The corollary of the above is that, under the present circumstances, no matter how and by what ever means Japan steps up importing from the United States, the U.S. trade deficit is unlikely to improve substantially. To believe that it will improve is a type of a fallacy of composition,

as explained in the above. So long as absorption (aggregate domestic demand) within the United States remains at the present level, when U.S. export to Japan increases as a result of lowering of Japan's supposed trade barriers, either U.S. export to countries other than Japan will decline, or imports into the United States from other countries (including Japan) will rise, and the United States's overall trade deficit will show virtually no change.

In the light of this simple macroeconomics, it is clear that the United States's bilateral trade deficit vis-a-vis Japan is the "result" of the United States's overall trade deficit or of the various factors behind it, and not the latter's "cause" ⁹⁾.

What, then, are these "factors giving rise to domestic absorption that is larger than supply capacity (GNP) at the full-employment level of the U.S. economy," which constitute the "cause" of trade deficits? Based on the definition of absorption, the most important ones are government spending in excess of tax revenues, high consumption and low savings rates in the household sector, and inadequate savings (retained earnings) in the corporate sector.

Since the U.S. trade balance was more or less balanced until the start of the 1980s, the "cause" of the United States's large trade deficit must be sought in the changes in exogenous variables and policy changes since then.¹⁰⁾ Given this, one can consider the U.S. budget deficit as the most important "cause" of the present U.S. trade deficit. A budget deficit reflects an excess of investment over savings within the government sector, and an increase in it unmistakably leads to widening trade deficit, unless compensated for by an increase in savings or a decline in investment within the private sector.¹¹⁾ In the case of the United States, the savings rate in the private sector which had already been low further declined after 1983, and did not

compensate for but widened the shortage of savings that the budget deficit had generated.

5. Measures to cope with trade deficits

Since a trade deficit reflects a situation in which aggregate domestic demand (absorption) exceeds aggregate supply (GNP), in order to reduce the trade deficit it is necessary either (1) that aggregate production be increased, or (2) that aggregate demand be reduced. On which of these stress should be placed depends upon whether the economy is in a state of full employment, and upon the length of the time horizon for improving balance of payments.

If it is necessary to improve a trade deficit in a situation which is not a state of full employment, the policies to increase output mentioned in (1) should be both effective and desirable. As production in a market economy is carried out in response to demand, measures to increase output will take the form of measures to divert demand of domestic residents as well as foreigners away from foreign-produced goods towards domestically-produced goods. Typical examples of such measures are (a) the depreciation of the national currency's exchange rate, and (b) measures to impose import quotas, raise tariffs, and grant export subsidies, although the latter are largely in violation of GATT (General Agreement on Tariffs and Trade). Also, (c) when the government restrains domestic demand and lowers domestic prices, and let enterprises strive for expanding export, it will have the effect of demand diversion abroad toward domestically-produced goods.

Even given a state of full employment, in the medium- to long-run it is possible to improve a trade deficit (d) by expanding the supply capacity through improved industrial productivity, technological innovations, and developing new industries and new markets. In the case of the demand-diversion measures in (a) and (b), and also in the case of

(d), an increase in aggregate production will be accompanied by an increase in aggregate expenditures, but since expenditures will normally increase less than output and savings more than investment, there is normally an improvement in the trade balance. In a state of full employment, however, if it is necessary to improve the trade deficit in the short-run, then there is no scope for the measures to increase output in (1), and the emphasis must be placed on the measures to restrain domestic demand in (2).

As there was excess capacity and unemployed labor in the U.S. economy in 1985, exchange-rate adjustments since the fall of 1985 led to an increase in export and a substantial decline in the ratio of the trade deficit to GNP, as we have seen earlier. Recently, however, the unemployment rate in the United States has continued to decline, and at present the U.S. economy may be considered to be virtually in a state of full employment. In view of this, the demand-diversion measures in (a) and (b) are likely to give rise to inflation, and will not be effective in improving the trade deficit. Since the current level of the trade deficit should not in itself be the cause of great concern to the United States in our view, as mentioned above, it would be wise to put a greater emphasis on improving the trade balance in the medium- and long-run through expanding supply capacity based upon improved industrial productivity and other measures in (d). Measures in (d) require increases in investment on plant and equipment, research and development, and educational efforts at various level. Therefore, it will be necessary to restrain domestic consumption and government expenditures through fiscal, monetary and tax policies on the one hand, and to increase expenditures for the above-mentioned purposes on the other hand.

If it is necessary to further improve the trade deficit in the short-run, as some Americans hold, then there is no alternative but to focus on measures to restrain domestic

demand, that is, (e) fiscal and monetary tightening, which is a standard measure to restrain aggregate demand.¹²⁾ Such a policy would not be an appropriate choice for the United States today, however, if the current level of the U.S. trade deficit is not in itself the cause of great concern, as explained in the above.

For many countries that have fallen into balance of payments difficulties since WWII, both U.S. economists and the U.S. government (through the IMF in which the United States has the largest voting power) have repeatedly advised or requested the adoption of the fiscal and monetary tightening measures in (e). Now that the United States contends that it has fallen into balance of payments difficulties which must be rectified, however, it demands its trading partners to expand domestic demand and open up their markets unilaterally, but the United States itself does not implement standard policy measures to improve its payments situation. This is a weird example of double standards.

Until today no deficit country other than the United States has ever demanded that surplus countries expand their domestic demand, criticized surplus countries that their domestic markets are less open, and demanded that they unilaterally lower their supposed trade barriers. Many countries that have fallen into balance of payments difficulties have been requested by the United States, through IMF, to undertake the measures, sometimes quite painful ones, necessary to improve their own payments problems ¹³⁾ and have done so and overcome the difficulties.

This asymmetry reveals that one of the principal causes of the politicization of the United States's trade deficit problems and of U.S.-Japan trade friction is the fact that the U.S. is what political scientists call a "hegemon" in the world politics, and that some Americans notably politicians have self-centered tendencies.

6. Trade barriers and the trade imbalance

There is a popular notion, especially among "Japan bashers" in the U.S., that the trade balance of countries with high tariff and nontariff barriers turns into surplus, and that the trade balance of countries with low barriers turns into deficit. There is virtually no relationship, however, between the trade balance and the height of trade barriers, both according to theory and as a matter of fact.

Looking first at facts, if one looks at the trade balance of various countries over a period of five to ten years or more, it should be immediately obvious that the determinants of the trade balance are macroeconomic factors in each country, in particular the factors exerting direct influences on the national savings and investment rates at the full employment (or the natural unemployment) level, and not tariff and nontariff barriers or the degree to which the market is open or closed.

Britain in the nineteenth century, the United States in the 1950s, and West Germany and Japan in recent years are examples of countries with domestic markets relatively more open than their trade partners and at the same time running fairly large trade surpluses. In the case of Britain in the nineteenth century, and also of Japan in recent years, the trade surplus rose in the process of extensive and unilateral trade liberalization.

By contrast, the countries that are regarded as being the most closed from the perspective of international trade, such as North Korea, Myanmar (Burma) and Albania, tend to run trade deficits, not surpluses. Also China, with its very high tariff and nontariff barriers, has also been incurring huge trade deficits in recent years. The trade balance of a considerable number of OECD's so-called "smaller countries" show a marked tendency towards deficits, although some of these nations have hitherto had fairly high import barriers.

Denmark and West Germany in recent years are highly revealing cases. Denmark has a large government deficit, the savings rate for its economy as a whole is low, and the current account deficit has persisted at an average of 3.1 percent of GNP for a period of eighteen years from 1970 to 1987. Its neighbor, West Germany, has almost balanced government budget, a high private sector savings rate, and its current account runs persistent surpluses (reaching 3.5 percent over the past five years). It is no wonder that in bilateral merchandise trade between the two countries Denmark is running a substantial trade deficit every year. It is clear that disparities in the trade balance of these two member countries of the European Community are attributable not to the differences in trade barriers but to differences in macroeconomic factors. The international payments situation of both countries is quite analogous to that of the United States and Japan, but since Denmark is not a "hegemon", it does not demand that West Germany unilaterally open up its markets or expand domestic demand.

Let us now turn to the theory. As stated in Section 3 above, trade deficit(surplus) is concomitant to capital import(export). If international capital movements are liberalized there will be countries that import capital over a long period, and others that export it. The reason for this is that the national savings rate (as a ratio of GNP) at the full employment level--or the savings rate over the medium- to long-term--varies from country to country, and the total savings in each country is not always equal to its total domestic investment. In an international economy in which international capital movements are basically free, capital will flow from countries in which the national savings rate is high relative to the domestic investment rate, to countries in which the savings rate is low relative to the investment rate. Or it will flow from countries in which the real rate of return on capital is low to countries

in which it is high. In this kind of global economic framework, there is no theoretical reason why countries in which the savings rate is high relative to its investment rate--or countries in which the real rate of return on investment is low--are countries with high trade barriers, and conversely that countries in which the investment rate is high relative to the savings rate or countries in which the real rate of return is high are countries with low barriers to trade.

Trade barriers that remain in place for a long period serve to hinder international trade and to reduce the volume of imports of goods or services to which they constitute barriers. This effects of the barriers, however, will be mostly offset by a decrease in exports or an increase in imports of other goods or services elsewhere, and therefore these barriers will have almost no impact on the trade balance. Thus generally they have no theoretical relationship with surpluses or deficits on the trade balance of the respective countries over the medium- to long-run. The latter are determined largely by how much households, enterprises and the governments of the respective countries save and invest at the full-employment(or the natural unemployment) level of GNP.

To be precise when full employment does not prevail in a country, if its trading partners lower trade barriers, then output and savings will rise as a result of the demand-diversion effect explained above, and the trade balance will improve. Even under conditions of full employment in a country, the lowering of trade barriers by a country's trading partner will bring about an improvement in that country's terms of trade, and could increase real incomes and raise the savings rate, bringing about some improvement in the trade balance. Yet in major industrialized countries such a terms of trade effect on savings resulting from a

lowering of trading partner's trade barriers will only be slight, and primarily of a temporary character ¹⁴⁾

II THE OPENNESS OR CLOSEDNESS OF JAPAN'S DOMESTIC MARKET

1. The openness of Japan's market

(1) Evidence of openness

Except for certain agricultural products, Japan's domestic market today is one of the most open among industrialized countries, in our view. The nationalistic or mercantilistic economic philosophy prevailing immediately after WWII until the first half of the 1960s, and the system of economic policy based on it with a strong emphasis on curbing imports, favoring domestically produced goods, and excluding foreign capital, have steadily given way to more rational economic policy. In today's Japan policy measures which embodied such an old economic philosophy have been largely dismantled ¹⁵⁾.

Some of the grounds for our judgement that the Japanese market is quite open are as follows. First, an international comparison of tariff rates, the number of goods subject to import quotas, and the number of voluntary export restraints (VER) requested of trading partners indicates that the Japan's market is at least as open as, and probably more open than, the U.S. and European markets in terms of these indices ¹⁶⁾. Second, since around 1975 the Japanese government has been continuously and strenuously implementing market-opening, barrier-reducing measures. Third, as a result of the sharp appreciation of the yen since the autumn of 1985 imports, particularly of manufactured goods, have increased quite substantially over the past few years ¹⁷⁾. Fourth, during the postwar period there have been vigorous new entries into many industries in Japan. As a result generally there are a larger number of powerful firms in an industry in Japan than in U.S. or West European countries. For example

there are five continuous-casting, blast-furnace steelmakers, eight independent automobile makers, and seven major computer makers, many of which are relatively new entrants. This attests to the fact the Japanese economy is quite open and highly competitive.

Even stronger evidence which points out the fact that the Japanese market is quite open, is an index which evaluates the business environment for foreign investors, periodically compiled and circulated by an American business consulting firm, the Business Environment Risk Information S.A. (BERI). This is one of the best known among "country risk" indices referred to by businessmen and experts in the field of international finance. While the other "country risk" indices mainly provide an evaluation of the risks in making capital loans, merchandise trade transactions, and portfolio investment in different countries, the special feature of information provided by BERI is that an evaluation of the risks of conducting new business operations in a foreign country is included in its indices. Namely BERI provides an "operations risk index", a "political risk index" which estimates the political stability of the country, a profit repatriation risk index, and the "Profit Opportunities Recommendation" index based upon these three indices.

BERI provides evaluations on 75 countries throughout the world based on a panel made up of about 100 experts all over the world and a panel consisting of about 75 specialists who analyze the political environment of each country. Among the fifteen criteria in the "operations risk index" are "the attitude towards foreign investors and profits", "bureaucracy", "enforceability of contracts", "local management and partners", and "availability of short-term credit" and "long-term loans" as well as macro-economic indicators such as economic growth, inflation, and the balance of payments.

In recent years the BERI "Profit Opportunities Recommendation" index has been rating Japan and Switzerland at the top two positions, indicating that Japan along with Switzerland are the best countries for foreign enterprise in terms of the profitability of new business operations there. The recent listings show that other major OECD countries are evaluated as follows: West Germany at the third position, the U.S. somewhere from fourth to seventh, U.K. from seventh to tenth, France from tenth to thirteenth, Canada from ninth to eleventh, and Italy from twentieth to twenty-fifth. With respect to the "political risk index" also, Japan is evaluated to be in the top group, together with Switzerland and Norway, distinctly above the U.S., the U.K., and France which are in the second group, meaning that Japan is evaluated by foreign political analysts to have a highest level of political stability.

As this assessment comes from the analysis and judgment of a large number of experts and specialists from all areas of the world, it may not be an exaggeration to say that Japan's markets are considered as the most open among developed countries. Even if this is going a little too far, the BERI index at least points out that it is groundless to call Japan a markedly "closed" country. It is not consistent for a country to be markedly "closed" to foreigners and at the same time to provide best profit opportunities for foreign enterprises planning to open new businesses.

Of course Japanese markets are not perfectly open, devoid of any tariff and non-tariff barriers. Japan does maintain tariff barriers, although they are low, and import quotas, a typical non-tariff barrier, for a number of agricultural products. Also, it cannot be denied that a large number of market opening measures have been put into effect recently and therefore the "openness" of the Japanese market is partly the result of these recent measures. If the various basic facts that have been presented thus far are

examined, however, it is evident that the "openness" of the Japanese market compares at least as favorably as with that of other major developed countries.

In spite of this, the myth that the Japan has numerous and high nontariff barriers (NTBs) and that its domestic market is closed is widely believed among foreigners, particularly the "Japan-bashers" in the United States. Yet they have never given sufficient evidence for their belief.

The usual "evidence" most frequently given by foreign critics, particularly "Japan-bashers", to prove that the Japan's market is "closed" is Japan's persistent trade surpluses. As explained in the previous section, however, the trade surplus or deficit of a country does not constitute grounds for claiming that its domestic market is closed or open.

Certain American economists are somewhat more sophisticated than non-economist "Japan-bashers," and give some other pieces of "evidence" to show that Japan's market is closed, but none of them cannot be taken as convincing evidence of supposed high trade barriers in Japan as will be seen below.

Apart from the international comparison of such indices as the average tariff rates, the number of import quotas, and the number of VERs requested of trading partners, it is difficult to show to what extent a country's domestic market is open or closed. Especially, it is very difficult to show convincingly that a country is quite open with respect to NTBs other than import quotas and VER's. The difficulties in doing so are somewhat similar to difficulties in proving that one did not commit a crime, say theft or murder, when one is suspected of having committed it but in fact did not. Unless one has a good alibi, which could well be unavailable, it is very difficult and nearly impossible to prove convincingly that one was not at all involved in the suspected crime. In case one did commit a crime in fact, it is much easier for

others to prove that he did, by giving material evidence and providing trustworthy witnesses. Hence we request those who assert that Japan's domestic market is closed, especially some U.S. economists and social scientists, to give scientific evidence which shows convincingly that Japan's market is more closed than the U.S. and West European markets, or to withdraw their unfounded assertion.

(2) Nature of nontariff barriers and their international comparison

There are a number of conceptual difficulties in making international comparison of the height of NTBs. First of all it is quite difficult to decide objectively what constitutes an NTB and what does not, since the judgements here even of those who are disinterested could frequently differ. For example there are often differences of opinion regarding the prohibition and limitation of imports for plant and animal quarantine reasons, or for the reasons of consumers safety, environmental conservation, or protection of intellectual property rights. In these cases the exporting countries may claim that the restriction in question is unnecessary or excessive and constitutes an NTB, while the importing country claims that it is a necessary and reasonable measure for the purpose of quarantine, consumers or environmental protection, or protection of intellectual property rights. In addition, among NTBs there are very few of which the height can be quantitatively measured, and for which international comparisons of this height are possible. Hence for many NTBs it is difficult to make the kind of international comparisons that are possible in the case of tariff barriers. Furthermore, it is still more difficult to measure and evaluate the effects of each NTB on the volume of imports.

Accordingly, apart from NTBs that were covered by the agreements of the GATT Tokyo Round, those currently being negotiated under the Uruguay Round, or those that could be

placed on the agenda for multinational negotiations in the future, it is generally not possible to establish scientifically whether a country's NTBs as a whole are higher or lower than those of another country.

(3) Confusion on the concepts of "NTBs" and "Closedness"

Recent arguments on "NTBs" and consequent "closedness" of Japan's market seem to have been confused by the lack of correct understanding of the concepts of "NTBs" and "closedness" themselves, in addition to fundamental difficulties in making international comparison of the height of NTBs mentioned above.

The concept of NTBs should be confined to barriers to trade, apart from tariffs, resulting from the actions of each country's government or from its legal institutions. Obstacles to trade resulting from the behavior of private-sector entities or social customs, for example obstacles created by differences in language or lifestyle, are not NTBs in the sense used in economics or economic policy discussions. Among the matters recently raised as constituting the alleged closedness of the Japanese market, quite a few are related to business practices, social customs, and actions undertaken by private-sector entities. From the principles of consumers' sovereignty and free enterprise, these matters should be left to the self-determination of private-sector entities, and generally there is no need for governments to intervene. It is fundamentally inappropriate to request, in inter-governmental trade negotiations, trade-partner governments to change these. Apart from conducting comparative studies of characteristics of various countries' markets from a social science research's viewpoint, for the purpose of mutually lowering NTBs through bilateral or multilateral arrangements, it would be wise to confine the NTB or "closedness" issues to barriers

to trade resulting from the actions of the government or from its legal institutions.

If not only NTBs and closedness in its proper sense, as explained above, but also social, cultural, and natural factors are considered, Japan's market could be considered as a relatively difficult market in terms of "penetration" by foreign firms and products, in comparison with other developed countries' markets. Japan is a country which has a large population, long history, unique language and lifestyle, and, moreover, it is far away from other developed countries which have similar levels of income and industrial technology.

Firms based in other industrialized countries would have more difficulties in penetrating into Japan's market, both through trade and through direct investment, than in penetrating into other industrialized countries which are more similar and nearer to their home markets. Viewed from the opposite side, Japanese firms have faced greater difficulties than European or U.S. firms in penetrating into countries in Europe and North America: it took many years for Japan's export industries to overcome such cultural, linguistic and social difficulties in penetration.

It is not appropriate to criticize Japan's market as being closed in view of the relatively greater difficulties in "penetration," which are due to social, cultural and historical factors unrelated to governmental interventions. It is based upon ignorance of the basis of international trade to claim that Japan should be excluded from the world free trade system because of the difficulties European and U.S. firms may encounter in penetrating Japan's market. International trade is by nature carried out between countries of which natural, cultural and social conditions are different, and the gains from international trade is the largest when trade is conducted between countries which are most different in such conditions. Basic provisions of

current GATT and IMF take this nature of international trade for granted. It is entirely wrong to assume that benefits of free trade exist only where the countries participating in international trade have similar social and cultural conditions and similar legal institutions.

2. Evidence that Japan's market is closed

Owing to space limitations it is impossible for us to take a detailed look at all the items that various foreign critics have put forward as grounds for asserting that Japan's domestic market is closed. In the following, however, we will outline our general views on the five items that we consider to be among the most representative items, cited by the critics: (1) the import of manufactured goods and intra-industry trade, (2) intra-firm trade, (3) *keiretsu* or corporate groupings and cartels, (4) differences between domestic and overseas prices, and (5) the distribution system.

(1) The import of manufactured goods and intra-industry trade

A number of U.S. economists have cited the low ratio of Japan's import of manufactured goods and the low ratio of "intra-industry trade" as the evidence that Japan's market is closed. There are various reasons why these two ratios are low, however, and low ratios cannot constitute a scientific evidence for the closedness of a country's domestic market¹⁸⁾. The following are the probable reasons why the ratios in question are low in Japan.

- (i) Japan has a very limited land area and has few natural (particularly energy) resources, and hence has strong comparative disadvantage in resource- and land-related sectors and strong comparative advantage in manufacturing industries.
- (ii) In Japan's neighbourhood there are no industrialized countries with common or similar income levels,

technological levels, language, writing system, history, culture, and social customs.

- (iii) Japan has strong comparative advantage in products that are produced by advanced technologies and are intensive in high-quality labor, in particular differentiated products requiring careful and meticulous final processing to cater to the needs of sophisticated consumers and other users.
- (iv) European and U.S. enterprises generally (with numerous important exceptions) do not yet know well what kinds of products and services are wanted by Japanese consumers and enterprises.

Professor Rudiger Dornbusch (MIT) argues the Japan's market is closed, based solely on the ground that the ratio of import of manufactures to GNP is low in Japan, which is an utterly unscientific ground, in our view. Moreover, he says that in Japan preferences and "social pressures" are against imports ¹⁹⁾, revealing his ignorance of Japan's economic history and realities. Ever since the Meiji period, Japanese people have habitually sought to buy all types of imported consumer's goods as well as capital goods, even though their prices were much higher. For a long time since Meiji and in post WWII years, imports meant products better than home-produced goods for Japanese. The preference of Japanese consumers, industrialists, and businessmen, who are generally well educated and have subtle and delicate preferences and requirements, for imported products has gradually diminished, however, because Japanese manufacturers have come to provide better products and fine-tuned services to satisfy their sophisticated needs. While preferences for imported goods still remain to an appreciable degree, there is hardly any social pressure against imports in Japan.

Most econometric analyses which conclude that the Japanese market is "closed" have some serious flaws. For example, in his paper on Japan's "closedness", Dr. Robert

Lawrence (Brookings) assumes that the utility functions of people in different countries are identical and "homothetic"²⁰⁾. Such an assumption is clearly inappropriate in analyzing actual problems of international trade. The needs of people in different countries are not identical, nor are their utility functions. What the Japanese demand are not the same as the Americans or Europeans do. Moreover, in countries with a low per capita income, consumer needs are not so sophisticated, whereas in countries with higher per capital income consumers are more sensitive to the subtle and delicate differences that exist between products. Hence the utility functions of a countries cannot be "homothetic". In Japan today, with the high level of per capita income and with the more and more sophissticated demands of Japanese consumers and other users, in order to be successful in marketing products, foreign firms have to conduct extensive research into their needs and develop and produce consumer goods that suit their taste, physical size, and lifestyle. For many years, Japanese firms have been studying the U.S. and European markets to find which products are likely to satisfy the needs of European and U.S. consumers and other users, and developing and producing such products. Most U.S. and European firms are only in the early stages of studying the Japanese market seriously.

The following are all important factors in determining the pattern of a country's international trade: 1) the degree of affinity with the trade-partner countries in the language, social and cultural traditions, and lifestyle, 2) the distance from the major industrialized countries, 3) the size of the population and that of the economy, and 4) the level of industrial technology.

For example, for a number of obvious reasons, New Zealand imports a lot of books and magazines per head, while Japan imports very little of books and magazines. Since currencies of the major countries shifted to a floating

exchange rate system in the early 1970s, depending on the relative values of the French franc and the British pound, in December of some years many Englishmen have travelled to Paris, while in December of some years many Frenchmen have travelled to London, for their Christmas shopping. In the case of Japan, however, there are no large capitals of neighboring countries with a similar level of per capita income where the Japanese can do December shopping. If exports of automobiles, ships and semiconductors from Korea and Taiwan increase, there will be an increase in Japanese exports to these countries of automobile engines, automotive electrical parts, machinery and apparatus with which ships are to be equipped, machine tools, and equipment and apparatus used in manufacturing semiconductors. On the other hand, these neighboring countries are virtually unable to supply Japan with any of these products requiring a relatively high level of technology. As these examples show the factors 1)-4) listed above are essential factors which have decisive influence on the patterns of each country's international trade. Yet Dr. Lawrence's study and many other similar econometric studies almost completely ignore these factors. Thus these econometric studies are utterly unscientific.

In order to prove "scientifically" the "closedness" of a country's domestic market, it is necessary, first, to identify the existence of trade barriers, namely those government interventions restricting or adversely affecting international trade, and, second, to show that these barriers have more restrictive effects on trade than similar barriers in other countries. A mere comparison of some ratios such as the import-GNP ratio, the ratio of manufactures in the total import or the intra-industry trade ratio, or an econometric analysis based upon unrealistic assumptions only reveals the importance of various factors such as 1)-4) mentioned in the above in determining the patterns of trade of different

countries, rather than the different levels of NTBs among countries.

(2) Intra-firm trade

There is an argument that a high ratio of "intra-firm trade" in Japan's international trade can be taken as an evidence of the closedness of Japan's market. Also the fact that Japan's ten largest trading companies account for a large proportion of the country's trade is taken as an evidence of the closedness of Japan's market. However, the relationship between the share of intra-firm transactions in a country's external trade on the one hand, and the degree of competitiveness, openness, and closedness of the market, on the other, has not yet been made clear. To begin with, what constitutes intra-firm trade and what does not is not well understood.

The statistics that are generally cited when discussing this issue are statistics on the operations of foreign-owned corporations, but the nature and composition of transactions between parent and subsidiary companies in this kind of statistics have not made clear yet, and no one really seems to have understood what is meant by the share of "intra-firm" trade. For example, suppose that in one country, purchases of imported wheat by a milling company are conducted as direct purchases by that company from a foreign country, while in another country these are conducted as purchases by a trading company's local subsidiary in the exporting country, an internal transaction between the subsidiary and its parent (intra-firm trade), and a sale by the trading company's parent to the milling company. In the latter case the import transaction is intra-firm trade, while it is not in the former. There is no essential difference in the competitiveness or the "closedness" of the market between the two ways of importing wheat, and there is little relation

between the ratio of this type of "intra-firm trade" and the openness or closedness of the country's market.

Also, it is by now a somewhat old-fashioned economic thinking to link intra-firm transactions directly with closedness, monopoly, or oligopoly. Today, the mainstream of economics of industrial organization and the theory of the firm considers enterprises as carrying out their business activities amid market mechanisms that are to a greater or lesser degree imperfect. In such an environment enterprises are considered as making case-by-case decisions as to which is the most efficient way in transferring resources and transmitting information: to use (a) the market, (b) an intra-firm organization, or (c) some form midway between these two. ²¹⁾

It is quite normal for enterprises to establish a sales network in overseas markets with a subsidiary in each country or region to take charge of the marketing therein of mass-produced differentiated products, such as automobiles, electronic products, machine tools and computers, which require advertising, user instructions, and after-sales services. Export of this type of products are generally conducted in the form of transactions between the parent company and its overseas subsidiaries. It would be no wonder to find Japan and other machine-exporting countries having a high ratio of intra-firm trade in its export.

Although Japan's ten largest trading companies account for a substantial share of the country's import and export, this does not constitute a proof of the closed nature of the Japan's market. Except for the items under import quotas or voluntary export restraints, generally Japan's import and export trade is highly competitive. One of the characteristics of the Japanese economy is that a large number of small- and medium-sized enterprises actively participate not only in production and distribution, but also in external trade and overseas direct investment. If a small

enterprise which exports or imports goods through a major trading company believes that the margins taken by the company are too large, it can switch to another major trading company or one of the countless smaller ones, or it can undertake export and import by itself. In fact there are numerous cases in which manufacturers that formerly exported their products through trading companies have, with the expansion of their overseas markets, switched to undertaking their export trade by themselves.

(3) *Keiretsu*, corporate groups, and cartels

The criticism is often raised that the existence of *keiretsu* (loosely translated as groups of affiliated enterprises), corporate groups, and cartels in Japan greatly restricts competition and impedes import. There are some basic difficulties with these criticisms, however. Traditional Anglo-Saxon economic philosophy holds that keen competition between enterprises constitutes a major driving force for economic growth. If competition is severely restricted in Japan, one can not explain why Japan has been developing at a much faster rate than the economies of other major industrialized countries. Thus either Anglo-Saxon economic philosophy is mistaken, and the U.S. antitrust policies to promote competition actually curb economic development and lower the economic welfare of the U.S. citizens, or the belief that the Japanese economy and markets are dominated by a small number of oligopolistic groups and cartels and is much less competitive than the U.S. is mistaken. In our view it is clearly the latter that is mistaken.

There is a widespread lack of understanding of Japan's *keiretsu* and corporate groups not only overseas, but also in Japan. *Keiretsu* is a loose word without a precise meaning and used in many different ways, so that one must be careful about what is being talked about when someone use the word

keiretsu. In our view peculiar phenomena of *keiretsu* and corporate groups in Japan, which differ somewhat from corporate groups found overseas, exist only in the three former *zaibatsu* groups--Mitsui, Mitsubishi, and Sumitomo. Other corporate groupings and long-standing business relationships in Japan are essentially no different from analogous phenomena found in other countries, and have a more or less similar degree of importance.

Corporate groups exist not only in Japan but in other countries as well. Long-standing (or fixed) business relationships characterized by the repetition of transactions between the same two (or more) enterprises are generally based on economic rationalities, and are widely observed in any industrialized economy. In the United States, for example, the relationship between a corporation and the investment banking firm which underwrites its stock and bond issues, or the relationship between a corporation and its advertising agency is generally a long-standing one. It does not mean that investment banking or the advertising business is not competitive. Even in fields in which long-standing business relationships are common, there are many firms competing with each other, and if some of them do not provide their customers with the same degree of satisfaction as others in the same industry in terms of product quality, types of services, and prices, there is always the possibility that these customers will turn away to other firms.

After WWII in Japan, a number of powerful firms have been competing vigorously in most fields, and often new entrants have brought technological innovations. In the process of rapid economic growth enterprises have always been in search of good suppliers to deal with, as regards product quality, prices, reliability of delivery, types of services and cooperation in research and development, in order to strengthen their own competitiveness. For each firm, the

prime consideration in this process has been to earn high profits for itself, not for some other firms whether or not within a *keiretsu* or a corporate group. When requested by another member firm of the same corporate group, a firm will not meet it unless it is in its own interest, from a long-term perspective. If it were to meet such requests leniently, its own competitiveness would be undermined.

Firms belonging to the same *zaibatsu* group frequently cooperate in launching into new fields and undertaking large scale overseas activities, and sometimes give support to weaker members within the group. For example there are cases in which employees of a firm that has fallen into business difficulties are re-employed by other firms within a group. However, such cases are exceptional, and are largely confined to the three former *zaibatsu* groups. Even in the case of these three former *zaibatsu* groups, the proportion of businesses conducted between member firms is now generally in the range of 10 to 15% of their total sales ²²⁾.

Corporate groups that are centered on a powerful corporation, such as Toyota, Matsushita, and Hitachi, are to be distinguished from the three former *zaibatsu* groups. In Japan a corporate unit is relatively small. Whereas manufacturing activities in several stages tend to be undertaken within one company in the United States, they tend to be spread over a number of separate corporate entities in Japan. Hence a number of closely related companies form a corporate group around a powerful "parent" company at its center ²³⁾.

The claim that cartels in general and what is called "*dango*" (consultation) in tendering in the construction industry in particular constitute a major NTB is, possibly with the exception of unusual cases, difficult for us to understand. While it is true that sanctions against cartels and *dango* under antitrust legislation are much less stringent in Japan than in the United States, if there are cartels and

"dango" in Japan that maintain prices at an artificially high level, it would make a new entry by foreign firms easier than otherwise. If Japanese firms operate *dango* at the time of tendering for government construction contracts, foreign construction firms would be able to win contracts more easily by submitting bids at prices lower than the *dango* prices. Generally speaking, even if cartels and *dango* are prevalent and sanctions against them are lenient in Japan, that cannot be said to constitute an NTBs. Possibilities of NTBs with respect to tenders for public construction projects could possibly be related not to *dango*, but to some aspects of the bidding system and/or to the way in which information is provided by the government agencies placing orders.

(4) Differences between domestic and overseas prices

The fact that prices in Japan are markedly higher than prices in other industrialized countries is often cited as evidence of the "closedness" of Japan's domestic market. In our view, however, among the items in which a marked domestic-overseas price spread are observed, those for which tariff and nontariff trade barriers can be considered the cause are rather few. Examples are rice, beef, and some other agricultural produce. The basic reason for price differences between Japan and overseas lies elsewhere.

The basic reason why Japanese consumers' and retail prices are high relative to international levels is that Japan has a strong comparative advantage in certain tradables (internationally traded goods), and the relative prices of these goods in Japan and elsewhere exert a dominant influence on the determination of the exchange rates. Many of the items that make up consumers' and retail prices are nontradables such as services and fresh foods. If the elements that make up their costs are analyzed, in most cases labor and land costs (rent, or the portion of profits

equivalent thereto, i.e. imputed rent) comprise a large proportion. In addition, wholesale and retail services, the cost of which constitutes the difference between producers' prices and retail prices, are also nontradables, and a predominant proportion of their costs comprises labor and land costs.

From 1985 to December 1987 as a result of a sharp yen appreciation the value of the yen vis-a-vis the U.S. dollar approximately doubled. Prior to 1985, the phenomenon of price differentials between Japan and abroad was not conspicuous as it is today. Hence one can say that the doubling of the yen exchange rate is the main cause of the emergence of these price differences. Despite such a large appreciation of the yen, wage rates measured in yen have not declined, but are steadily rising at almost the same rate as before. As a result, Japan's domestic wage rates and labor costs measured in U.S. dollars have almost doubled within about two years and are still rising. The situation is similar with regard to the cost of land, which in major cities has further risen sharply by a surge in land prices (yen-denominated) in 1986-1988. These factors are the principal reasons why Japanese consumers' and retail prices are high relative to international levels. ²⁴⁾

Another cause of price differences between Japan and overseas is what is called "price discrimination" in economics, practiced by firms with a dominant market position. Firms of this type sell at a high price in markets where they consider that the price elasticity of demand for their product is low, and at a low price in markets where they consider that the price elasticity is high. Price discrimination is pervasive corporate behavior, widely practiced both domestically and in international trade. ²⁵⁾

There is a general tendency for both Japanese and foreign firms to consider that the price elasticity of demand is lower in Japan than abroad, and hence to sell at higher

prices in Japan than in foreign countries (including the foreign firms' home markets). For example, certain European manufacturers of such products as automobiles, skis, whisky, brandy, perfumes, and handbags adopt high price policies in Japan, and their 100 percent owned subsidiaries and sole agents in Japan are earning huge profits from such discriminatory price policies. In this type of situation the Japanese government is not in a position to order the foreign manufacturers, their subsidiaries or sole agents to lower selling prices in Japan. There is little alternative but to hope that more "arbitraging" import will be undertaken ²⁶⁾, and that Japanese consumers will become wiser and more prudent, thus raising the price elasticity of demand in question.

(5) Distribution system

Foreigners and foreign governments have frequently been criticizing that Japan's distribution system is of labyrinthine complexity, is inefficient, and constitutes an NTB. In our view, however, Japan's distribution system is highly competitive and dynamic, and is at least as efficient as the distribution system of other industrialized countries.

Over the past decade or two, numerous innovations have taken place in Japan's distribution system: the spread of supermarkets; discount stores; mass retailers of home appliance, consumer electronic products, cameras and watches; mass-sales chain-stores for spectacles, furniture, men's clothing, and shoes; convenience store chains operating around the clock (or similarly long hours); the development of mail-order business; the establishment of wholesaling and distribution centers; and the introduction of the point-of-sales system. As in other fields of the Japanese economy, the distribution system in Japan is alive with vigorous competitors, new entrants, and remarkable innovators. A flow of innovative retail and wholesale firms providing new type

of services that meet consumer needs at low cost are coming in, developing, and succeeding.

International comparisons of distribution margins seems to reveal that there is virtually no difference in margins between Japan and the United States. Moreover, Japanese retailers and wholesaling generally seem to be providing better services than their counterparts in other developed countries ²⁷⁾.

The Large-Scale Store Law (Law Concerning the Adjustment of Retail Business Operations in Large-Scale Retail Stores) and licensing systems for some retailing businesses such as liquors, rice, pharmaceuticals, and tobacco undoubtedly restrict competition in the retail trade, and thus may have the effect of increasing distribution margins to some extent. In our view, however, there are strong enough forces of competition in most sector of Japan's distribution system and these restrictive features therefore do not affect much the general trend of margins.

If the Japanese distribution sector is inefficient, and firms in the U.S. distribution sector are more efficient, they would presumably be successful in participating into Japan's domestic retailing and wholesaling. It is claimed that high land prices in Japan block the entry of U.S. distribution firms into Japan's market. However, new type of innovative Japanese distribution firms have been buying or leasing the land they require at high prices, opened a large number of new large-scale store every year in spite of the Large-Scale Store Law, and been scoring a great success.

In this kind of affairs, the U.S. government position is not quite clear to us. Presumably if, say, the Large-Scale Stores Act is repealed or revised, so that there will be no or less restrictions on the opening of large-scale stores, that would make distribution of imports easier, and increase Japan's volume of import of manufactures. But, first, by how much? Does it lead to an appreciable improvement in the U.S.

trade deficit? Second, the above is a very simple-minded reasoning based upon what is called a "partial equilibrium analysis" in economics, which takes into account only the immediate, localized effects of a policy change. It may be valid in a short-run, but may well not in a medium- or long-run. According to macroeconomic analysis an improved efficiency of the distribution system will increase real income of the Japanese people, and Japan's saving is likely to be increased as a result of an increase in real income, and if domestic investment remains unchanged the trade surplus will increase, which is roughly equal to the difference between saving and domestic investment. What really does the U.S. government want through its requests to the Japanese government in the areas of Japan's distribution system, antitrust laws and land taxation?

III CRITICISM OF THE "SECTION 301 APPROACH"

1. The "Section 301 approach"

As the U.S. trade deficit has been widening since the mid-1980s, the U.S. has been increasingly using Section 301 of the 1974 Trade Act and the various related provisions in the trade law such as the so-called Super 301 provision of the Omnibus Trade and Competitiveness Act of 1988, in its effort to increase U.S. export. This "Section 301 (and Super 301) approach", including the cases where the above-mentioned provisions have not directly been applied but are used or viewed as a potential threat, is a form of U.S. trade policy strategy or a U.S. government's course of action in recent years, in which the U.S. identifies nontariff barriers (NTBs) of the trade partners, requests the unilateral removal or lowering of such NTBs through negotiations, and should these negotiations fail, makes to resort to sanctions such as raising tariff rates or introducing import quotas, without going through the GATT dispute-settlement procedures.

The following perception seems to lie behind the increasing orientation towards the "Section 301 Approach". This perception posits that the cause of the U.S. trade deficit is the flagging of U.S. export as a result of NTBs erected by trading partners, and that unless the United States adopts resolute measures to remove or lower these NTBs, its trade balance will not improve. It is believed that Section 301 and the related provisions will act as a crowbar to prize open these NTBs, and that this will increase export opportunities for U.S. enterprises. The basic thinking underlying the Section 301 Approach is the use of a crowbar to increase opportunities for U.S. export.

However, in its legal, economic, and political aspects, both the appropriateness and effectiveness of the Section 301 Approach are open to serious doubt.

2. Legal aspects

From the legal standpoint a fundamental difficulty with the Section 301 Approach is that it is not consistent with GATT. Under Section 301 and the Super 301 provisions, if U.S. negotiations to remove or lower NTBs fail, the U.S. imposes import quotas and other sanctions. If the U.S. were to unilaterally apply sanctions in this event against a trade partner which is a GATT member without following GATT dispute-settlement procedures, the U.S. would violate the nondiscriminatory most-favored-nation(MFN) treatment principle of GATT. In fact almost all the United States's major trade partners are a GATT member. There are complicated problems regarding the validity of GATT under the U.S. domestic law, but internationally the United States as a GATT member is bound by the GATT rules. It is thus beyond question that unilateral sanctions as part of the Section 301 Approach are in conflict with its obligations under international law.

Also, even apart from the use of sanctions, just the act of identifying trade partners' certain practices as an NTB without going through GATT dispute-settlement procedures cannot escape the charge of being arbitrary. As pointed out in Section II above, the opinions about what constitutes an NTB and what does not frequently differ among even the disinterested people, and it is often difficult to arrive at an objective decision. Accordingly, if a dispute over this point arises between GATT members, a decision should naturally be left not to just one of the parties in dispute but to a third party, as is provided for in Article 23 of GATT. As commented on by many people, in the Section 301 Approach the United States simultaneously plays the roles of both the plaintiff (or the prosecutor) and the judge within the international community, which does not satisfy the conditions for due process of law. This is quite disturbing to the international legal order.

3. Economic aspects

From the economic standpoint there are major doubts about the effectiveness of the Section 301 Approach in expanding U.S. exports. Firstly, the removal of NTBs at which the Section 301 Approach is directed is unlikely to make a substantial contribution to the expansion of U.S. export. As is mentioned above, it is no easy task to judge whether or not something constitutes an NTB. Even if it can be objectively judged as an NTB, it is often difficult to assess the extent to which it reduces imports. Indeed, it has not been clearly shown whether the majority of items claimed by the U.S. government as constituting NTBs in Japan are in fact NTBs, and to what extent U.S. export is reduced by them.

Secondly, under present U.S. macroeconomic conditions of full(or nearly full) employment it is unlikely that the removal or lowering of even the genuine NTBs by U.S. trade

partners contributes to reduce the United States's trade deficit. Those who are unfamiliar with macroeconomics appear to believe that the Section 301 Approach can improve the U.S. trade balance, but as explained in Section I above, the present U.S. deficit is caused basically by macroeconomic factors. Even if the Section 301 Approach were to succeed in removing or lowering some of the trade partners' genuine NTBs related to certain items, thereby increasing export of those items from the United States, the increased production of these items in the United States would cause either a decline in export of other items or an increase in imports into the United States, unless U.S.'s total domestic demand is reduced or somehow the aggregate supply increased. Hence it is unlikely to result in a marked improvement in the overall trade balance of the U.S..

Thus not only is the Section 301 Approach ineffective in macroeconomic terms, but it has also an undesirable negative side effect: namely to distract the attention of the people of the United States away from making the improvements in macroeconomic factors that are essential in alleviating the trade deficit.

4. Political aspects

When the U.S. pursues the Section 301 Approach and requests a trade partner to remove or lower NTBs, if the latter considers the U.S. demand to be reasonable, it may accept the request and take the necessary measures to remove the trade barriers. There would be relatively few such cases, however. When for many years the United States has been unilaterally demanding a variety of trade concessions to its trade partner, as in the case of Japan, and when the latter has already acceded to such a demand with respect to a large number of items, it is unlikely that the government officials, firms and workers in the areas concerned, and the general public in the trade-partner country take new,

additional demands presented by the United States as being reasonable and acceptable.

Furthermore, from the viewpoint of the U.S. trading partners there are many tariff and nontariff barriers on the U.S. side. Import into the U.S. of such important products as all kinds of textiles, footwear, steel, automobiles, machine tools, and semiconductors are being markedly restrained through obvious NTBs, including import quotas under the Multi-Fiber Agreement (MFA), and voluntary export restraints (VER) arrangements requested by the U.S., and very high rates of anti-dumping tariffs without any time limits. Under such circumstances, it is not probable that U.S. trade partners will accept the U.S. unilateral demand as being reasonable.

It is natural that the trading partner would wish to entrust the identification of NTBs designated by the U.S. and the remedial measures thereof to the judgement of a third party under the GATT rule. In addition, many of them would wish that if they lower NTBs in response to U.S. demands, then the United States also lowers its NTBs in exchange.

In the bilateral trade negotiations since the sixteenth and seventeenth centuries it has been a traditional practice for two countries to mutually lower tariff rates so that the results of negotiations would have approximately the same favorable effects on the two countries' export. This is a long-standing "wisdom" in trade negotiations because although generally the lowering of tariff and other trade barriers is not only desirable for the trade partner but also beneficial to the country as a whole lowering them it often involves sacrifices of specific interest groups adversely affected by the lowering of trade barriers. Therefore the lowering of trade barriers is often politically difficult. Accordingly, it has become the widespread practice for both countries to lower tariff rates mutually and simultaneously, so that that the "political pains" accompanying freer trade are shared

between the two countries concerned. This wisdom of sharing the political pains accompanying the move towards freer trade has been carried over to the GATT, especially in its multilateral negotiations such as the Kennedy Round, the Tokyo Round and the Uruguay Round. Removing or lowering NTBs in a "fair" way is far more difficult than the lowering of tariff rates in a "fair" way. Therefore it would be quite important that groups of people in a country adversely affected by the lowering recognize that the hardships are shared by similar groups in the other country (or countries), so that they are persuaded to cooperate in the efforts towards freer trade. Nevertheless, the Section 301 Approach is completely devoid of this wisdom prized in trade negotiations since the sixteenth and seventeenth centuries.

The fact that the United States's trade partners make concessions in response to the United States requests along the lines of the Section 301 Approach does not necessarily mean that they consider the U.S. demands as reasonable. In many cases it is because they consider that the retaliatory measures which would be adopted by the powerful United States could greatly reduce their access to the U.S. market, and moreover the trade dispute with the U.S. could have harmful effects on the other aspects of the bilateral relations with the U.S.

In any event, if unilateral demands by the United States are made repeatedly along the lines of the Section 301 Approach, and the government of a trade partner makes a series of concessions, the outcome may be as follows. First, within the trade-partner country there will be a buildup of dissatisfaction in industries that are adversely affected by the repeated unilateral concessions to the United States. Discontent of this kind is alleviated if the U.S. lower or remove tariff and nontariff barriers at the same time, and the hardships caused by the lowering of trade barriers are shared by similar groups in U.S., whereas under the Section

301 Approach, the hardships and political pains are inflicted only on one side of the negotiation. Such discontent and resentment may spread beyond the parties directly involved. Thus, in exchange for securing trading opportunities for certain U.S. industries and firms, the use of the Section 301 Approach by the U.S. government risks weakening the influence of pro-American groups in foreign countries and fanning anti-American emotions. Second, if the U.S. government frequently resorts to the Section 301 Approach, some other countries may begin to use a similar "crowbars" approach to trade affairs, if they consider themselves able to exert a sufficiently large restraining influence by threatening with unilateral sanctions. If a number of countries begin to adopt such an Section 301 type approach, the outcome will be the spread of tit-for-tat retaliations and a plunge away from the rule of law into disorder in the world trade system and a contraction of international trade ²⁸⁾.

As one of the foremost leaders of free, multilateral world trade, the U.S. is presently participating in the GATT Uruguay Round negotiations which are attempting to strengthen the free world trade system. For the U.S. to use the Section 301 Approach which involves unilateral sanctions in violation of the existing GATT rules on the one hand, and to work to strengthen the GATT rules and to request other countries' cooperation on the other hand, is clearly contradictory. From this viewpoint as well, the use of the Section 301 Approach in U.S. trade policy, is thought to be a politically unwise policy.

It is hoped that the U.S. government officials and politicians come to recognize fully the flaws in the Section 301 Approach, as explained above, and that the U.S. proceed squarely with macroeconomic adjustments aimed at raising its national savings rate and reducing the budget deficit, which are the real problems crucial for the future of the country.

CONCLUSIONS

Considered in the light of standard economic theory, the present level of the United States's trade deficit should not in itself be a cause of concern. Japan's large trade surplus reflects the supply of capital (savings) by Japan necessary for the economic development of various countries around the world. In view of the basic principles underlying today's world trade system, which seeks to liberalize and stimulate international capital movements, it is a mistake to blame Japan for its trade surplus. If the United States does not wish to have a trade deficit, and hence does not wish to import capital it should improve the trade balance by employing the orthodox balance of payments measures recommended in the past by U.S. government and U.S. economists to many countries which have run into payments difficulties since WWII. What the United States should be concerned about is not so much the trade deficit in itself as the very low level of savings for the entire economy and the concomitant low level of domestic investment.

The bilateral trade imbalance between the United States and Japan is the result of the respective countries' overall trade imbalance, not the cause. The fundamental cause of the United States's trade deficit is macroeconomic factors in the U.S. economy, in particular the massive budget deficit and the low savings rate in the private sector. Unless there is improvement in those factors, there is little hope of further narrowing the U.S. trade deficit.

Over the medium- and long-terms, tariff and nontariff barriers have virtually no effect on the current account of the countries concerned. Japan today is one of the most "open" countries among OECD members with lower levels of both tariff and nontariff barriers than most others. No U.S. economists nor others have provided scientific evidence to show that Japan's domestic market is less open than the U.S.

market. The claim that Japan's market is closed is an unfounded "myth" based upon misunderstandings. The "Section 301 Approach" to the trade problems has serious shortcomings from legal, economic and political standpoints. Even if the U.S. succeeds in lowering what it alleges to be Japan's and other countries' NTBs by the Section 301 approach, that will have virtually no effect of improving the U.S. trade deficit. Hopefully, the United States will return to the orthodox economic theories and standard policy measures which it has been preaching for many years since WWII to deficit countries in order to overcome balance of payments difficulties. In particular, if the United States deems it necessary or desirable to improve the trade deficit in medium- to long-run, the United States should endeavor to curb its domestic demand, raise its low savings rate and expand supply capabilities through improved industrial productivity.

With respect to U.S.-Japan trade problems, one of the reasons why the plain common-sense understanding of the U.S. trade deficit based upon standard economics has not become more commonly held may be that there is a deep-rooted view which envisages the U.S.-Japan economic relationship as a process of competition for global economic hegemony. But such a view is a mistaken one. A struggle for political and military hegemony is essentially a zero-sum (or minus-sum) game, whereas economic relations constitute a non-zero-sum game with plus-sum payoffs to participants. For both the United States and Japan, there is only limited areas in which their economic interests conflict, whereas the areas in which they have common interests are by far larger. The U.S. should cease placing emphasis on negotiations that politicize bilateral trade issues with Japan and needlessly exacerbate friction. Instead U.S. and Japan should cooperate towards strengthening the global free-trade system by jointly working towards the success of the Uruguay Round .

NOTES

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1. See Ryutaro Komiya, *The Contemporary Japanese Economy* (in Japanese) (University of Tokyo Press, 1988), pp. 333-376. For a survey of Japan's trade and trade policy since the 1950's to the present, see Ryotaro Komiya and Motoshige Itoh, "Japan's International Trade and Trade Policy: 1955-1984," in T. Inoguchi and D. Okimoto, eds., *The Political Economy of Japan, Vol. 2: The Changing International Context* (Stanford: Stanford University Press, 1988).
2. Unless otherwise indicated, "trade balance" and "trade deficit (surplus)" in this paper refer respectively to the balance of goods and services trade and its deficit (surplus). This balance is a sum of the merchandise and invisible (services) trade balances, and is equivalent to the current account minus the unilateral transfer account. In developed countries such as the U.S. and Japan, the trade balance here defined is roughly equal to current account balance because of the small relative size of the unilateral transfer account.

3. The theory of the balance of payments and of policies to overcome the balance of payment difficulties first developed by James Meade and Harry G. Johnson is found in standard textbooks of international economies, such as Paul R. Krugman and Maurice Obstfeld, *International Economics: Theory and Policy* (Glenview, Il.: Scott, Foreman and Company, 1988, pp. 519-23, and John Williamson, *The Open Economy and the World Economy: A Textbook in International Economics* (New York: Basic Books Inc. 1983), pp. 160-165.

4. The following simple computation explains this point. Let us assume:

(a) that the United States's net external assets are currently zero,

(b) that the price level remains stable and there is no change in the terms of trade,

(c) that the U.S. sustains an annual trade deficit of 2.5% of GNP, and

(d) that its real growth rate is zero.

Then the United States's ratio of net external debt to GNP would be 25% after ten years from now. If instead of (d) we assume

(d') that U.S. real GNP grows at 2% per year over ten years,

then the net external debt after ten years would be not 25%, but 22.9% of GNP at that time. In addition, if instead of (c) we assume

(c') that the deficit on trade balance excluding investment incomes (interests, dividends and other returns on investments) is 2.5% of GNP annually, and that the real rate

(excluding the portion accounted for by price rises) of interest (and other returns on investment) is 3% per year,

then the net external debt after ten years would be 26.1% (and therefore the annual real interest burden would be 0.8%) of GNP then in the case of (d')). If the real interest burden is 4%, the net external debt after ten years would be 27.3% (1.1%) of GNP.

In relation to this point, we received a comment that there may be a difference in the level of difficulty required to improve current account balance in a large economy such as the U.S. as compared with smaller countries shown in Table 3. Judging from the fact, however, that most of the U.S. trade partners were able to promptly adjust to the changes when the U.S. current account rapidly turned to large deficits in a short period from 1982 to 1984, we do not see that improving current account is more difficult in U.S. than in other countries due to the difference in size.

5. Strictly speaking, this should be current account deficit (surplus). See note 2.
6. See Article 1(a) of the OECD Code of Liberalization of Capital Movements, and Article IV Section 1 of the IMF Articles of Agreement.
7. "Absorption" means the amount of goods and services that are used for consumption and investment, and disappear from the economic circulation.
8. In the light of Macroeconomics, equations such as (1), (2), or (3) are no more than one of the equations which constitute a macroeconomic model. Of course, these equations include variables such as gross national product (GNP), consumption, investment, savings, export, and import, which are influenced by various endogenous and exogenous variables. In spite of this, statements in the text are so worded as largely correct as a first approximation.
9. A criticism to Japan has recently emerged in the United States to the effect that, whereas the U.S. bilateral

trade deficit with Europe has been virtually eliminated by the currency adjustments since the autumn of 1985, the bilateral trade deficit with Japan has been reduced little, and thus Japan is a peculiar--or even a "bad"--country. Another view frequently encountered in the U.S. is that although West Germany's current account surplus is greater than Japan's in terms of a ratio to GNP--even in absolute size, at the time of this writing--, this is accounted for by surpluses with other European Community countries and not with U.S., and thus West Germany is not a "bad" country from the U.S. viewpoint.

Arguments of this type are unacceptable. In fact it is wrong to consider Japan a "peculiar" country in this regard, since the exchange rate changes since September 1985 have had quite a "normal" result on Japan's balance of payments on current account. Between the third quarter of 1985 and the fourth quarter of 1988 the effective exchange rate of the yen appreciated by 59%, giving rise to a strong J-curve effect in Japan's current account balance in 1986 and 1987. After going through this J-curve effect, Japan's current account surplus as a ratio of GNP shrunk remarkably, to 2.13% in the third quarter of 1989, compared with 3.92% in the third quarter of 1985, and with 4.76% at the peak of the J-curve in the second quarter of 1986. Thus, from the Japanese point of view, the currency adjustments have functioned quite normally. The reason why U.S.-Japan bilateral trade imbalance in terms of the dollar has only slightly decreased is largely due to the following two facts. First the U.S.'s initial overall deficit in terms of the dollar was huge, and secondly depreciation of the dollar with respect to the yen was very large, amounting to about 90% during the above-mentioned period. Hence the U.S.-Japan bilateral trade imbalance in terms of the yen had shrunk substantially (29.8%), while that in terms of

the dollar had expanded (17.0%) rather than shrunk, over the period from the third quarter of 1985 to the fourth quarter of 1988.

To state it in fundamental terms, moreover, it is quite natural in a multilateral free-trade system that a country's trade balance will be in surplus with some countries and in deficit with others. Although at present Japan's overall trade balance is in a large surplus, its bilateral balance with a country with which it traditionally has a deficit such as Canada, Australia, or Middle-East countries is today still in deficit. The United States's trade balance has traditionally been in deficit with Japan and East Asia, and in surplus with Europe and Australia. As the United States's overall trade deficit has recently been declining in terms of ratio to GNP, its surplus with Europe is beginning to reappear. The criticism to Japan cited here is based upon an old-fashioned bilateral approach to the balance of trade which cannot be upheld under the multilateral framework of the GATT and IMF.

10. The assertion has been made by some U.S. officials that 80 percent of the causes of the United States's trade deficit are due to problems on the U.S. side, but that the remaining 20 percent are due to problems on the side of its trade partners, in particular Japan, and thus the United States should demand Japan to open its market, and negotiate vigorously to that effect. However, this assertion is inappropriate for a number of reasons.

First, as stated earlier, the United States's trade balance has turned into large deficit since 1983. The "cause" of this should be sought among changes that have occurred since around 1983. Japan's NTBs which are alleged to have existed for a long time cannot be the "cause" of the United States's recent large trade deficits, even assuming that they do exist.

Second, unless absorption is restrained or the supply capacity is increased within the United States, the U.S. trade deficit will not decrease, whatever is done with regard to Japan's alleged NTBs. As a matter of fact despite a series of lowering of tariff and nontariff barriers by Japan since around 1976, the U.S. overall trade deficit widened rather than narrowed until 1987.

Third, for the United States to demand its trade partner countries to make unilateral concessions in the spheres of macroeconomic and trade policies for the supposed benefit to the United States --be it in the form of the lowering of NTBs or the expansion of domestic demand--is seen to be unreasonable from the perspective of each country's sovereignty over national economic policies in an international community.

11. Although there exists no fully satisfactory theoretical understanding of exchange-rate movements under the floating rate system, the mechanism through which a budget deficit is thought to increase trade deficit is the following: government bond issues to finance the budget deficit raise domestic interest rates, leading to an increase in capital inflows and an appreciation of the country's currency, thereby causing the trade balance to turn into deficit or the existing deficit to widen.
12. If domestic aggregate demand is restrained by restrictive fiscal and monetary policies, aggregate production also tends to decline to some extent, but it is normally the case that expenditure declines more than production, and investment more than savings, thereby improving the trade balance.
13. During the 1960s the United Kingdom fell into the balance of payments difficulties several times, and when it sought an IMF credit it was required to implement fiscal and monetary tightening measures. In one of such occasions the Opposition criticised the government in

Parliament that IMF's interference in U.K.'s fiscal and monetary policies constituted an encroachment of its sovereignty, but the U.K. government had to accept the requirements. As this example shows, for proud countries it is unpleasant and difficult to have other countries or international institutions interfere in their fiscal and monetary policies. But in an international community the government of each country must be responsible for the balance of payments difficulties which have been caused largely by its own mismanagement, and must take necessary measures to overcome them however unpleasant or painful it is to do so. The United States's seems to be too proud, and appears to be prone to disregard its responsibilities and obligations under the international law.

14. At the time of the two oil crises, Japan's current account balance turned into large deficits, but the deficits did not last for long. This is because the decline (rise) of the savings rate caused by an deterioration (improvement) in the terms of trade is generally transient.
15. There remain, however, localized interest groups here and there maintaining the vestiges of old protectionist policies, and it is often difficult to eradicate them completely.
16. The rate of tariffs on manufactures in Japan is 2.1% in 1987, less than half the rate in the United States (4.3%) and the European Community (4.6%). The number of items of manufactures subject to "residual import restrictions" is only one for Japan, while it is thirteen for France and three for Italy. The United States has let its trade partners institute voluntary export restraints on such major imports as steel, consumer electronic products, automobiles, machine tools, semiconductors, beef, and several other items, and the European Community has done

- so on steel and textiles (it also imposes "monitoring" of automobiles and VCRs), whereas Japan has not formally requested the trade partner countries to impose one.
17. Measured by the import volume index, overall import increased by 39.7% over the three years 1985~1988, and imports of manufactured products by 80.0%. The share of manufactured products in imports rose sharply from 31% in 1985, to 49% in 1988.
 18. For example, the U.S. imports as a percentage of GNP between 1960 and 1964 were only 3.1% on average. This was lower than the percentage for Japan and much lower than that for the West European countries then. One cannot conclude from this low percentage, however, that the U.S. economy at that time was more closed than the Japanese or West European economies (see Table 4).
 19. See Rudiger Dornbusch, [1989a], "Give Japan a Target and Say 'Import!'," (*The New York Times*, September 24, 1989), "Prescriptions for U.S.-Japan Conflicts" (in Japanese), *Nihon Keizai Shinbun*, November 28-29, 1989.
 20. See Robert Z. Lawrence, "Imports in Japan: Closed Markets or Minds?," *Brookings Papers on Economic Activity*, (1987, No. 2) pp. 517-48.
 21. See Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications--A Study in the Economics of Internal Organization* (New York, Free Press, 1987), and Ken'ichi Imai, Hiroyuki Itami, and Kazuo Koike, *Economics of Internal Organizations* (in Japanese), (Toyo Keizai Shinpo-sha, 1982).
 22. According to a study by the Fair Trade Commission, for companies within one of the three former zaibatsu groups (excluding companies engaged in finance) the share of the other members of the same group in their sales was 13.4% on the average, and the share of the same in their procurement was 14.8%, in fiscal 1981. These ratios are probably declining in recent years.

23. Production activities which are spread over several companies in Japan, are often conducted in a single mammoth corporate organization in the United States. For example, Du Pont is approximately six times larger than Asahi Chemical in terms of sales, but its number of employees is roughly nine times larger. Similarly, both General Motors and General Electric are about twice as large as Toyota and Hitachi, respectively, in terms of sales, but approximately eleven times and four times, respectively, larger than the latter in terms of the number of employees. There is no prima facie reason to say that the U.S. industries in which these highly integrated mammoth corporations exist are less "closed" to outsiders than Japanese industries where large manufacturing companies depend extensively on subcontractors from which they procure parts, supplies and services on a long-standing basis.
24. A similar situation existed in the United States during the 1950s. According to an international comparison of purchasing power of the currencies of OEEC countries conducted by M. Gilbert and I. Kravis, *An International Comparison of National Products and Purchasing Power of Currencies* (Paris: OEEC, 1954). in the early 1950's, consumer prices in the United States then were approximately 1.6 times higher than in the United Kingdom, France, and West Germany. Using the same method as Gilbert and Kravis, one of the authors of this paper (Komiya) and a collaborator compared the purchasing power of the yen and the dollar, and found that U.S. consumer prices were approximately double those in Japan in 1952 (T. Watanabe and R. Komiya, "Findings from Price Comparisons: Principally Japan vs. the United States," *Weltwirtschaftliches Archiv*, Band 81, Heft 1 (1958). U.S. prices were very high then because the United States had a strong comparative advantage in a wide range of

tradable goods, and because it kept the exchange rate of the U.S. dollar at a much higher level than the level commensurate with the purchasing power parity based upon consumers' prices, and not because the U.S. domestic market was closed.

25. Discriminatory pricing policies by enterprises engaged in international trade are regulated by respective countries' antidumping legislation, when sales at low prices in the importing country cause damage to industries in that country, and the GATT antidumping code largely allows such legislation. However, both the current GATT antidumping code and U.S. and other countries' antidumping legislation tend to give excessive protection to producers' interests to the neglect of the interests of consumers, and lack economic rationality. See Ryutaro Komiya and Akihiro Amano, *International Economics* (in Japanese), (Iwanami Shoten, 1972), pp. 123-28.
26. However, it is obviously inappropriate to implement policies that infringe upon the legitimate patent and trademark rights of foreign manufacturers, their sales subsidiaries or sole import agents .
27. For example, in Japan it is quite common for fish retailers to slice fresh fish ---and even grill it sometimes---when desired by a customer, and to deliver it in time for the customer's evening meal. If a book wanted by a customer is not found in a bookstore, or the right size of a desired pair of shoes is not in stock at a retail shoe store, generally the retailers procure them from wholesalers within a week to two at the most. Japanese who have lived in U.S. and West European countries almost unanimously say that the services provided by U.S. or European retail stores are substantially poorer in quality than that of Japanese retail stores.

28. From a similar point of view, William A. Niskanen, formerly a member of the Council of Economic Advisors (1981-85), says "world trade can survive little bullies, for their actions can be avoided or effectively countered. But it cannot survive a big bully [the U.S.]". See William A. Niskanen, "The Bully of World Trade," *Orbis* (Fall 1989), pp. 538.

Table 1: U.S. Current Account Deficit and Japan's Current Account Surplus:
1980-1989 (as ratios of GNP)

(unit:%)

	U.S.	JAPAN		U.S.	JAPAN
1980 I	-0.32	-2.49	1985 I	-2.40	2.26
II	-0.08	-1.81	II	-3.06	4.23
III	-0.01	-0.38	III	-3.20	3.92
IV	0.45	0.21	IV	-3.08	4.08
1981 I	0.39	-0.69	1986 I	-2.99	2.94
II	0.21	0.52	II	-3.40	4.76
III	-0.24	1.29	III	-3.70	4.56
IV	0.28	0.65	IV	-3.27	4.93
1982 I	0.03	-0.33	1987 I	-2.72	3.79
II	0.29	0.95	II	-3.50	3.82
III	-1.05	1.13	III	-3.87	3.58
IV	-0.71	0.88	IV	-2.55	3.40
1983 I	-0.43	0.48	1988 I	-2.29	2.59
II	-1.09	2.18	II	-2.80	2.60
III	-1.68	2.42	III	-3.00	2.74
IV	-1.68	2.18	IV	-2.25	3.17
1984 I	-1.96	1.53	1989 I	-2.03	2.16
II	-3.03	3.10	II	-2.45	2.05
III	-3.36	2.82	III	-2.10	2.13
IV	-2.90	3.71			

Source: IMF, International Financial Statistics.

Table 2: Net Capital Inflow and Outflow(-) of U.K. and U.S.: 1860-1914
(as ratios of GNP)

(unit:%)

	U.K.	U.S.
1860-69	-3.69	-----
1870-79*	-4.73	1.01
1880-89**	-5.85	0.69
1890-99	-3.57	0.05
1900-09	-4.69	-0.40
1910-14***	-9.24	0.09

* :1869-78 for U.S.

** :1879-88 for U.S.

***:1910-13 for U.K.

Sources:[U.K.] A.H. Imlah, Economic Elements in Pax Britannica, Harvard University Press, 1858.

B.R. Mitchel and P. Deane, Abstract of British Historical Statistics, Cambridge University Press, 1962.

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[U.S.] Jeffrey G. Williamson, American Growth and the Balance of Payments 1820-1913, The University of North Carolina Press, 1964.

U.S. Department of Commerce, Historical Statistics of the United States.

Table 3: Net Capital Inflow or Outflow(-) of Some OECD "Smaller Countries"
: 1970-1988 (as ratios of GNP)

(unit:%)

Country	Average(1970-79)	Average(1980-88)	Maximum
Denmark	3.4	4.4	8.4 (1987)
Greece	4.7	5.4	8.7 (1985)
Ireland	7.5	7.1	15.4 (1980)
Norway	6.8	0.6	14.0 (1977)
Portugal	1.4 *	5.0 **	15.4 (1982)
Australia	2.2	5.4	8.3 (1982)
U.S.	-1.0	1.4	3.0 (1985)

* :Average for 1972-79

** :Average for 1980-86

Source: IMF, International Financial Statistics.

Table 4: Merchandize Imports of U.S. and Japan: 1960-1969 (as ratios of GNP)

(unit:%)

	U.S.	JAPAN
1960	3.2	10.2
1961	3.0	10.7
1962	3.1	9.3
1963	3.1	9.7
1964	3.1	9.7
1965	3.3	9.0
1966	3.6	9.0
1967	3.5	9.4
1968	4.0	8.9
1969	4.0	8.7

Source: IMF, International Financial Statistics.