Reevaluating Past Policy Approaches to U.S.-Japan Trade Problems

William V. Rapp

Commercial Counselor, U.S. Embassy in Tokyo*

Introduction

The interaction of the U.S. and Japanese economies over the postwar period on the whole has been extremely beneficial. However, the policies and performance of the two nations have been a study in contrasts. Initially, the U.S. dominated the relationship and ran a large bilateral surplus. Then, as Japan's industrial strategy bore fruit, the positions reversed. We now hear the cry of “Japan as Number One.” Yet both countries have need for a strong economic and political relationship. For this to be successful in the long run, it also must be seen as balanced and mutually advantageous.

The U.S. has made tremendous accommodation to Japanese growth by opening its markets to Japanese goods: textiles, consumer electronics, steel, automobiles, machine tools, telecommunications, and others. Japanese auto and steel companies are selling almost 25 and 10 percent of their production, respectively, in the U.S. market. Some Japanese policymakers have claimed that the U.S. economy is weak.

*Appointed March 6, 1983. This paper was written, however, while the author was a vice president at the Bank of America.
However, during the 1970s, the U.S. made this kind of accommodation while raising total employment 25 percent compared to 9 percent in Japan.

The Japanese economy also has performed strongly, consistently raising productivity, maintaining price stability, and increasing the trade surplus. Indeed, it has performed well, particularly in those areas where faulty U.S. macroeconomic policies have not provided appropriate supports. This policy mismatch has proved explosive for U.S.-Japanese relations, politically and economically over time. The difficult environment has been compounded further by a growing U.S. perception that Japan has not accommodated U.S. competitiveness in certain areas in the same way the U.S. has Japan’s. Specific industries include high technology, aluminum, petrochemicals, caustic soda, leather, agricultural commodities, and pulp and paper, to name a few. These specific issues have recently combined with high U.S. versus low Japanese unemployment rates to raise bilateral tensions to a new level. It is difficult for U.S. policymakers to push fully the benefits of free trade when such an unemployment differential exists, and U.S. goods do not seem to have the same market access due to Japanese “special circumstances.” This issue goes well beyond the large bilateral trade imbalance that Japanese policymakers prefer to touch on but dismiss as irrelevant in a multilateral trading environment.

The industry-specific problems could be handled better if the overall, or macroeconomic, context in both countries were more favorable. In the U.S., despite a structural shift toward services, the economy requires a higher saving rate and a lower interest rate policy to bring improvement about. In Japan, lower administered interest rates need to combine with a substitution of capital for oil and a lower saving rate to rectify the economic imbalance. Pursuing these goals mutually would have tremendous benefits for both countries and the world, as interest rates generally would be able to fall and oil prices to stabilize. Bilaterally, the yen should then get stronger, putting less competitive pressure on U.S. industry, including high technology, while U.S. industry should become more competitive. The reduction of oil imports also should help accommodate increased imports from the U.S. in areas such as paper without creating a weaker yen. At the same time, both countries should experience higher rates of growth as should the world economy. The positive fallout to other economies and the world financial system from higher real growth and lower interest rates is obvious. Also obvious is lessened trade conflict given falling unemployment and reduced pressures on exports to service debt.
Postwar Policies and the Tertiary Economy

Something is wrong with the U.S. economy and/or the policies used to guide it. Traditional attempts to control inflation seem to have aggravated it. Escalating interest rates have raised costs, exacerbated federal budget deficits, and reduced productive investment. Lower investment levels due to higher capital costs in turn have lowered U.S. productivity and competitiveness relative to foreign producers, e.g., Japan. As U.S. products have become less competitive domestically and overseas, imports have increased, export market share has declined, the trade balance has deteriorated, and inflationary pressures have been compounded. All this occurred even before high interest rates and an uncertain world economic environment led to dollar appreciation, putting U.S. industry at an additional disadvantage. A “strong” dollar due to the impact of high interest rates on exchange rates should not blind us to the weakness of U.S. industry and the price we are paying in terms of the short- and long-term competitiveness of U.S. goods, given current monetary and fiscal policies. High prices usually mean a permanent loss of market share as well as less incentive to invest in new capacity. Further, what will happen when we must pay the interest and principal to foreign investors, notwithstanding that much of the deficit financed has been for consumption goods and services, not investment? Also, will the world be prepared to accept a major outflow of U.S. goods and services to fund our growing foreign debt? Similarly, high interest rates are compounding the federal deficit, which decreases overall savings and increases the potential for crowding-out.

High technology and service sectors in terms of new investment requirements are relatively less sensitive to interest rates than the old-line, capital-intensive manufacturing sector. Therefore, the recent rise in interest rates played on the basic economic differences among the sectors to accelerate the reallocation of resources toward services and high technology:

a) Tight money policies raised costs to the interest-sensitive sectors, depressing both consumption (e.g., housing and autos) and investment demand (e.g., steel, metals, autos, machine tools).

b) Tax policies discouraged investments because depreciation allowances based on historical cost, even after the investment tax credit, were inadequate, given accelerating cost inflation. In consequence, those industries that depended less on physical than on human capital gained relatively.
c) Fiscal policies fostered consumption at the expense of savings, raising capital costs and retarding investment, particularly in old-line industries. Keynesian policies may be appropriate to get us out of a great depression. However, in an inflationary, capital-short environment they do not provide the economic basis for an effective competitive trade strategy vis-à-vis a capital surplus country such as Japan.

Therefore, rationalization of the traditional areas of the economy was discouraged while the post-industrial sector was encouraged. Countries such as Japan, though, were pursuing contrary tax and fiscal policies that promoted savings and investment by sheltering earnings on savings and capital gains and by accelerating depreciation. Established manufacturing sectors became relatively much more productive and competitive than their U.S. counterparts. This further reduced demand for new investment in old-line U.S. industries as they lost market share domestically and overseas. It also meant that these industries were not able to pass along the full amount of capital and other cost increases through higher prices. Therefore, they faced positive real interest rates in the 1970s when other sectors were looking at negative rates.

Gradually, U.S. basic manufacturing facilities became competitively obsolete. The oil crisis and the dramatic rise in energy costs that accompanied it, coupled with greater inflation, higher interest rates, increased capital requirements, and more capital-using government regulations, combined to deliver the coup de grâce. Since old-line industries are more energy-intensive and capital-intensive than the high technology sector, they suffer far more from an environment of high interest rates and elevated energy costs. Their problems are secular, not merely cyclical. In addition, Japan with more abundant capital could turn these increased capital requirements and higher costs for U.S. companies into a continuing long-term advantage. This changing comparative advantage would not have occurred as swiftly if the U.S. had been generating a greater amount of savings. Companies would have been able to manage normal evolutionary change in a lower interest rate environment as their Japanese counterparts have, in fact, been able to manage their recent evolutionary changes.

Some argue that to a large degree the high technology and service industries inevitably will continue to gain relatively and the old-line industries will continue to decline in importance. They then advise on what those in specific industries or sectors should do to manage these
apparent changes. However, given the regional concentration of these industries (traditional industry in the Midwest and Northeast but energy, high technology and services in the Sunbelt), this advice has serious political consequences that impact on national stability. That is especially true when one realizes that minorities, particularly younger people, account for a very high percentage of unemployment in depressed areas.

An alternative approach to controlling an increasingly diverse and segmented economy would be to devise a set of policy initiatives to cope with inflation, redress the current economic disadvantage of old-line manufacturing, and promote higher economic growth generally. Such a development policy could be greatly enhanced through a significant increase in the domestic rate of saving. Indeed, without such an increase it is unlikely that such a program could be successful. For example, it is argued that many old-line industries are badly managed and focus too much on the near term. However, without greater savings and lower nominal interest rates (though higher real after-tax rates to attract savings), demand for their products is unlikely to improve. Costs will remain high; new investments will be difficult to justify; and the discount on future earnings will remain large. There only so much management can do when the economy is operating below the optimal level of savings and investment. This optimal level would seem to be that needed for the fastest non-inflationary per-capita income increase to take place at a rate sufficient to keep unemployment low and U.S. industries competitive. As we shall see later, Japan in fact has problems because it exceeds this rate. But its competitive problems are much less than those of the U.S. For the U.S., a key issue is how to increase savings.

A savings incentive package should specifically improve the real after-tax returns on savings in financial assets. Proposals to set up tax-free investment accounts represent one such possibility. Under these proposals, withdrawals are treated as earnings, capital gains, or principal recapture (in that order) and are taxed at current capital gains or zero rates accordingly. One advantage of such proposals, as with any proposals to tax consumption, such as VAT, is that there is no immediate reduction in tax revenues as there has been, for example, with the increased IRAs, which have deferred substantial portions of taxable revenues with no direct link to increased net assets. A transfer of assets under our proposal does not by itself create a tax deduction. Further, the program could be designed to shelter only financial assets that represent a net increase in savings so that only true monetary
savings from income or the sale of non-monetary assets, net of any increased borrowings, would be eligible for the tax-exempt investment account. This approach would mean that the stimulative effect of a higher saving rate on the economy via lower interest costs would tend to increase tax revenues and lower government debt-service requirements rather than the reverse. Thus, there should be little negative savings impact from a growing budget deficit as the tax-incentive program for savings takes effect.

These factors create a powerful incentive to effect an increase in gross savings (total savings as a percent of GNP) and an even larger savings flow into financial markets, where it would be available for real productive investment. There are those who argue that increased savings are not necessary because there are substantial unused savings already available to the economy in unused capacity and unemployment. This view misses the fact that this capacity is and has been uncompetitive in the domestic and world marketplaces. Otherwise it would be utilized, and we would not be uncompetitive with Japan. In fact, because of the oil crisis and increased government regulations, a large portion of traditional U.S. manufacturing capacity is economically, if not physically, obsolete. Conversely, Japanese producers have used their cheaper capital to make the needed energy-saving and modernization investments. They also have scrapped plants where even these efforts cannot work. Some U.S. industry was more affected by the energy crisis than foreign producers who had been facing high energy prices for some time and had become less energy-intensive in their production processes.

The combination of increased supply capacity and greater investment, supported by higher real savings, is a very powerful force in terms of both improving long-term growth and price performance, as Japan has dramatically illustrated. This combination satisfies demand pressures while improving supply performance in a sustainable way. In turn, the government stands ready to buttress demand through fiscal initiatives if that should become necessary. Given America's present economic structure, a policy emphasizing high gross and monetary saving rates is both important and achievable, as illustrated by Japanese experience. Japan's high saving rate has allowed her to absorb the very large capital-using effects of pollution control and other regulations. Price stability and improved export performance have helped keep her economy at growth levels that remain the highest in the OECD.
Table I

<table>
<thead>
<tr>
<th>JAPANESE AND U.S. SAVING RATES AND SAVING UTILIZATION</th>
<th>Japan</th>
<th>U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Saving Rate (percent of GNP)</td>
<td>32</td>
<td>20</td>
</tr>
<tr>
<td>including government saving</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Used for: (percent of GNP)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Replacement capital</td>
<td>14</td>
<td>10 to 11</td>
</tr>
<tr>
<td>Residential housing</td>
<td>6 to 7</td>
<td>4 to 5</td>
</tr>
<tr>
<td>Net non-residential investment</td>
<td>11-12</td>
<td>4-5</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulatory burden on residual for new investment</td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Gives:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net investment available for growth</td>
<td>9.5 to 11.5</td>
<td>2.5 to 3.5</td>
</tr>
<tr>
<td>Divided by:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital output ratio</td>
<td>2</td>
<td>1.5</td>
</tr>
<tr>
<td>Equals:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real GNP growth rate from net new productive investment (percent)</td>
<td>4.75 to 5.25</td>
<td>1.7 to 2.25</td>
</tr>
<tr>
<td>U.S. growth shortfall compared to Japan</td>
<td></td>
<td>2.5 to 3.5</td>
</tr>
<tr>
<td>U.S. GNP saving rate shortfall (growth shortfall times capital output ratio)</td>
<td>3.75 to 5.25</td>
<td></td>
</tr>
</tbody>
</table>

A couple of simple numerical examples can best illustrate the reasons for this performance as well as the competitive implications for U.S. industry of a high Japanese saving rate (see Table I). Japan currently is saving about 32 percent of GNP, including government investment, while the U.S. is saving around 20 percent. Of this, 14 percent of total GNP in Japan is for replacement capital, compared with 10 to 11 percent in the U.S. This higher percent of GNP going to replacement
capital reflects Japan’s higher relative level of industrialization, as industry is more capital-intensive than the government or service sectors. After allowing for residential housing, this leaves 11 to 12 percent and 4 to 5 percent of GNP in Japan and the U.S., respectively, for new productive investment. However, in each country government regulations for pollution control, and so on, are estimated to impose an additional burden of about 1.5 percent of GNP. The burden of these regulations, though, on the U.S., relative to new capital resources available to promote growth, is nearly three times greater than on Japan. That is because 1.5 percent of GNP represents only 12.5 percent to 13.6 percent of savings available for new investment in Japan, compared with 30.0 to 37.5 percent in the U.S. Thus, the negative impact on U.S. economic growth potential has been proportionately much larger.

Indeed, since Japan is in an excess saving position, requiring massive deficit financing, i.e., government dissaving as an offset, studies indicate that environmental, energy, and other regulations actually improved growth by forcing business to make investments they would not have made otherwise. These regulations also have put some Japanese firms in the forefront of certain pollution-control technologies. The inflationary burden on the economy and the resistance of Japanese business have logically been much less than in the U.S.

For the U.S. economy to perform similarly, given our somewhat lower capital output ratio of roughly 1.5 to 1.7, we would have to raise our gross saving rate to around 25 percent of GNP. That is, a 2.5 to 3.5 percent growth shortfall means a 5 percent current saving rate; our target should be 24 to 25 percent of GNP. This is, however, not that different from levels achieved by many other countries. Perhaps the surprising thing should be how well we have done so far with such a low rate of saving. This has been due primarily to expansion of service and high technology industries and also partly due to the rest of the world’s, and particularly Japan’s, willingness to lend us their savings, i.e., our balance of payments deficit. That is, of course, the major source of trade friction between Japan and the U.S., as these savings take the form of Japanese exports.

Given Japan’s greater saving rate, capital charges have not increased as have U.S. charges. The prime rate in Japan toward the middle of 1983 was almost 2 percentage points below that in the U.S., enabling firms in Japan to use lower discount rates. With lower investment hurdle rates (i.e., the discount rate used to establish investment payback in discounted cash-flow analysis), Japanese firms can logically
afford to undertake projects with longer paybacks. U.S. firms would consider such paybacks marginal. This may prove a particularly acute problem for U.S. firms if the situation allows Japanese firms to preempt some important future products or processes that their U.S. counterparts cannot currently justify due to higher required rates of return. In this sense a high saving rate underpins Japanese business’s vaunted “long-term” perspective. Lower hurdle rates increase the number of investments that can be justified. They also raise the value of future market share. Conversely, high U.S. rates may make liquidation of markets much more attractive than future earnings for U.S. companies. Thus, a tight monetary policy sends managers a conflicting signal relative to the nation’s desire for U.S. companies to stay in business and to invest for long-term competitiveness and employment. Unfortunately, only such investment leads to productivity improvements, maintenance of market share, and long-term competitiveness. The relationship of successful management and appropriate monetary and fiscal policy is much closer than usually thought.

For example, under this capital-cost-differential scenario for the U.S. and Japan, the concept of equivalent operating costs is naturally unstable. Because higher growth potential and lower capital costs encourage investment and productivity gains, Japanese manufacturers compound their long-term advantage. Nor is this likely to change since current Ministry of Finance (MOF) loan restraints on Japanese banks effectively prevent foreign firms from accessing low-cost, long-term yen funds. On the other side, many U.S. treasurers are loath to take on such exposure anyway, given their bad experience with deutschmarks and Swiss francs in the 1970s. Therefore, while arbitrage effectively equates fully-hedged rates in the short-term market, one or two years out, that is not true for long-term rates.

The Reagan administration program seeks to reduce total government spending. It has shortened depreciation schedules and skewed personal tax reductions moderately toward higher income brackets. These policies should increase saving, but not sufficiently to increase the 19 to 20 percent (including government investment) rate we have now to the 25 percent of GNP we probably need to accomplish our goals. Also, the tax reductions and incentives provided leave too much to chance. The tax-free savings certificate and an expanded IRA program do increase real after-tax returns and should help the monetary saving rate. But they are not likely to impact the gross rate very much until interest compounds and is plowed back. Additionally, to the extent people have just transferred existing assets or, worse, borrowed
to take advantage of the tax benefits, there may have been a net reduction in both personal and government saving, compounding our present problem.

The program should rather be more targeted to increasing absolute savings by giving incentives primarily for new savings, particularly new monetary savings, and by locking-in these benefits through allowing reinvested earnings to compound tax-free until withdrawn. Also, investment incentives should have differentiated between new plants and scrap and build at existing sites to improve the efficient use of existing capital stock, especially social overhead. Replication of social facilities in new population centers is an inefficient use of scarce capital resources. Such a program also would help alleviate potential sun- and snow-belt tensions in the future.

Tax and fiscal incentive strategy should focus constantly on a particular proposal's impact on saving. In Japan, for example, within the Ministry of Finance there is a director for saving promotions. In this light, proposals to substitute a value added tax (VAT) or a consumption tax for certain corporate or personal income taxes, such as double taxation on dividends, would clearly improve the incentive to save by discouraging consumption. Also, tax is avoided only if net savings actually increase. From this standpoint, the recently-enacted tax on gasoline promotes saving, especially if part of it is used to reduce the projected deficit.

The Japanese Postwar Environment

There is a feeling that if one takes the U.S. and reverses it, one will find Japan. Certainly, the current economic policy environment is no exception. Whereas the U.S. is suffering from a saving shortage, which has raised capital costs domestically and to the rest of the world as well, Japan has too much relative to current investment demands. This situation evolved from Japan’s compulsion after World War II to develop a competitive manufacturing sector that would pay for needed food, raw material, and energy imports. This in turn necessitated a high level of non-inflationary investment. Unlike the U.S., Japanese fiscal, tax, and monetary policies were used both to stimulate monetary savings and to direct those funds toward industry.

Thus, a variety of institutional and political arrangements were put in place, the sum of which has been labeled “industrial policy,” a term currently much in vogue among Japan’s major competitors in the West. The arrangements in turn promoted and provided an environment
Reevaluating U.S.-Japan Trade Problems

Conducive to rapid competitive economic growth in which manufacturing costs and prices were reduced, export markets were penetrated and expanded, and the economy achieved unprecedented growth and success. There was also an intentional upgrading of products and industries from textiles to steel to autos to computers. Upgrading occurred within industries, too, as from cotton to synthetic textiles or carbon steel to specialty steels.3

The labor and financial systems developed in a complementary manner, as rapid growth resulted in expanding opportunities to work and lend money. The so-called permanent employment system and seniority wage structure for large firms meant that workers were hired directly out of school and given pay raises based on longevity. Thus, rapid growth lowered average wage costs, stimulating more growth and investment as lower costs translated into lower prices. Similarly, government support for high growth and its willingness through the Banl of Japan to rediscout corporate loans permitted Japanese banks to extend loans aggressively. Japanese firms could grow and finance investments unconstrained by equity growth as U.S. firms tend to be. Debt ratios soared, allowing more aggressive pricing through lower after-tax capital costs.4

As Japan's industry and, in turn, economy prospered, the permanent employment system, the seniority wage structure, the investment and savings incentives became institutionalized and self-reinforcing. There appeared no upward limit to growth as long as markets could be found for the output. By 1972 Japan was saving close to 40 percent of GNP. However, in the early 1970s the oil crisis, protectionist pressures in advanced countries, and the LDCs' desires to process more of their own raw materials combined with growing domestic concern with pollution, the environment, and the adverse consequences of growth as a sole national goal acted to constrain marketing increases and the growth psychology. The saving incentives, though, continued. Tax-free savings accounts, no taxes on capital gains, and rapid depreciation allowances all remained in place. In addition, rapid inflation triggered by the oil crisis and the Tanaka Plan to decentralize created tremendous uncertainty. Under these circumstances, desired personal saving actually rose while desired investment demand was falling in response to mature domestic markets in Japan and slower export growth.

Given this environment, Japan now was generating excess saving at high employment levels for which there was no corresponding investment demand. That was, of course, the reverse of the U.S. economic environment. Thus, the Japanese had to find alternative ways of using
these resources. During the period from 1973 to the present, the
government has increased public works investment and has moved
from essentially no budget deficit to one as high as 6 percent of GNP.
However, the rapid rise in government debt has alarmed MOF officials,
who now have imposed zero-base budgeting. Many programs have
faced real budget decreases. Business leaders have called for admin-
istrative reforms to reduce the deficit. But with reduced government
dissaving, the question arises, how will savings be used? Massive net
exports are not acceptable to the rest of the world, beset by unem-
ployment problems. The new knowledge-intensive industries, as noted
for the U.S., are not that capital-intensive. Yet, if savings are not used,
economic activity will fall so that ex post savings equals investment.
This has adverse consequences for Japanese industries and, in turn,
those countries that supply Japan with raw materials and other goods.
It also worsens the government deficit by lowering tax revenues. Thus,
excess saving can be almost as bad as not enough.

Because interest rates are still fairly high by historical standards, a
logical proposal would be to lower rates to stimulate demand for
investment and consumer durables. The MOF has resisted this because
it feels such action would further weaken the yen as people borrowed
yen and bought dollars. This development in turn would raise protec-
tionist pressures in the U.S. and elsewhere. However, the MOF is
perhaps being overcautionary in this regard since exports are only 10
percent of GNP and even less on a value-added basis. Thus, lowering
interest rates should have a much more stimulative effect on the
domestic economy and on imports than on exports. Also, with the rest
of the world not growing rapidly, it is not clear how much a weaker
yen would stimulate export demand. Therefore, some lowering of
interest rates in concert with U.S. rates would seem to make sense.
Certainly, recent declines in U.S. rates and the sympathetic apprecia-
tion of the yen allow some moves in that direction.

Two other action programs would clearly help the situation: 1) reduc-
ing the fiscal and tax stimulus to save, and 2) substituting capital
for oil through a massive phase-out of oil-fired power stations. Both
programs were introduced to a limited degree but have since been
pulled back due to apparent institutional biases and an inability to reach
a consensus. For example, to reduce cheating on tax-free saving ac-
counts, the MOF proposed and was set to introduce a taxpayer
number system, or green card. But due to pressure, particularly from
wealthy Liberal Democratic Party (LDP) supporters, the program was
postponed to 1984 and essentially killed. Similarly, while the govern-
ment stopped building new oil-fired power plants after the Iranian crisis and promoted development of LNG, coal, and nuclear plants, these stations, especially the two latter kinds, were essentially destined for new or planned power-generation capacity rather than as direct substitutes for current plants. This apparently was due to the resistance of Japanese utilities to the cost involved plus local resistance to particular sites for new stations.

Japanese policymakers must overcome their current lack of consensus and resist special interest groups that oppose lower interest rates, energy substitution, and reduced incentives to save. The benefits accruing to Japan, its major trading partners, and the world economy more than justify this. Looking at each proposal in turn, we see the following detailed aspects requiring analysis.

Lowering interest rates in Japan presents some unusual political difficulties. Bank rates on normal deposits remain regulated, and the Japanese short- and long-term prime is tied to these. The MOF thus has the power to lower bank rates directly. However, the Postal Savings System competes directly with the banks for available funds from the general public, and postal saving rates are controlled by the Ministry of Post and Telecommunications. In effect, bank rates cannot be lowered without the cooperation of the Ministry of Post. In turn, there is a lot of pressure from small savers, agricultural cooperatives, and consumer groups to maintain higher rates on postal savings. Also, as postal savings are a major haven for "illegal" tax-free accounts, the MOF has been trying to capture, some major LDP contributors also are involved.

In addition, a competitive money market for larger participants, such as corporations and financial institutions, has emerged in the last few years, and it is closely tied to foreign exchange transactions. Corporate and financial participants in these money markets are also often major players in the foreign exchange market. Any attempt to lower regulated rates will require, consequently, some increase in the money supply to lower market rates, too. And such lowering would put further downward pressure on the yen. Downward interest rate pressures due to excess saving is, therefore, being resisted by the Ministry of Post due to political pressures, by the Bank of Japan due to inflationary concerns of an expanded money supply, and by the MOF due to foreign exchange concerns vis-

Nevertheless, lower rates would stimulate demand for housing and consumer durables and, in turn, investment demand. It would also at the margin reduce the incentive to save. These developments clearly would stimulate growth, given the current excess saving environment.
Income growth should then raise tax revenues, which could be used for more demand-stimulative monetary and fiscal policies, i.e., even lower interest rates and tax cuts. Since the domestic economy is considerably larger than the export economy and the external economic environment is depressed, the initial impact of domestic expansion due to lower interest rates should be to increase imports more than exports.

Japan can benefit substantially itself, as well as the rest of the world, by further reducing energy dependence on oil. Japan is currently the world’s second largest oil importer after the United States. But unlike the U.S., most of Japan’s oil comes from the Middle East and most is used for power-generation. A large reduction in Japanese oil requirements for electricity certainly would help to stabilize oil prices even in the face of a strong economic recovery. Downward pressures on real oil prices would serve to redistribute resources back from OPEC to the rest of the world. This development not only would help Japan but would benefit many of its major trading partners in Asia such as Korea, Taiwan, and the Philippines.

The major way for Japan to reduce oil imports would be by constructing new coal and nuclear power plants while phasing out existing oil-fired facilities. This also would provide substantial investment demand to use up some of the current excess savings without ballooning the government deficit. Rather, the power utility companies would borrow more to fund the program. Nor would this approach initially involve substantial siting or engineering problems. Several already approved projects have been scaled back or postponed because of the current recession and lower than expected economic growth projections for the 1980s.

What is lacking is sufficient incentives and compensation to the utilities and the oil industry to undertake such a substitution program. Naturally, the government would need to discuss with them an appropriate package. However, some possibilities might include the following:

1. Special tax credit and immediate depreciation for scrapping existing oil-fired plants when a coal-fired plant replaces it at the same or an alternative site. The emphasis should be on coal as such plants can be built more quickly, do not have the social and political problems that surround nuclear facilities, and would have a beneficial impact on such major coal-supplying trading partners as Australia, Canada, China, and the U.S.
2. Low cost credit to finance the plants could be provided by the Japan Development Bank. Alternatively, special bonds for this
program could carry a tax-free coupon, and on a one-time basis people might be allowed to transfer funds from currently illegal savings accounts to these bonds. Thus, this program might be combined with introduction of the green card.

3. The Ministry of International Trade and Industry (MITI) could allow the utilities to share more in the cost-savings generated by the switch from oil to coal or nuclear by not fully adjusting rates. That is, it would permit utilities to capture part of the cost-savings from using a cheaper fuel to achieve a yield higher than the target rate of return they normally would use in setting power rates.

4. Utilities would be allowed more rapid depreciation allowances on coal and nuclear plants than on oil, with permission to sell tax benefits, including the scrap, and build credit if the utilities cannot use them.

5. Oil suppliers would be offered similar funds and tax benefits to compensate them for revising their refinery mix and for scrapping any unneeded facilities. They also could be given preference as coal and uranium suppliers and as builders of any required facilities to handle these alternative fuels.

Although the above suggestions would create some negative impact on government revenues at first, the deficit would not be as great as it would be if the government itself made an expenditure equivalent to the new investments by the utilities. Secondly, over a period of years, the stimulus to the economy due to a higher level of investment, a stronger yen, and lower energy costs would increase revenues and reduce the deficit.

This program also would serve to offset some of the MOF's current difficulties in trying to stimulate the economy without raising the deficit or lowering interest rates and weakening the yen. In this case the utilities would make greater investment expenditures and interest rates would fall less. Also, as coal or nuclear fuel were substituted for oil, imported fuel costs would go down and the yen would be strengthened. A stronger yen then would allow for some reduction in rates without fomenting political pressures from the U.S. or the EC. Another benefit would be that investment demand would focus on heavy industry and construction, which are currently particularly depressed.

It is, of course, possible, maybe even likely, that such massive substitution of capital for oil might still fail to use up all excess savings available. Therefore, despite the Ministry of Post and the banker...
associations, it is important that the MOF push ahead on the third point: reducing or channeling (i.e., through tax-exempt power-conversion bonds) some of the current saving incentives. This could be done by introducing a green card system and changing regulations surrounding consumer credit (such as promoting a central credit bureau or allowing retail establishments to extend credit). The ratio of outstanding consumer credit, excluding mortgages, to personal disposable income in Japan in 1980 was only 7 percent, compared to 22 percent in the U.S.5 In addition, the MOF should consider allowing deductibility of interest for mortgages on new houses for a limited period, say the first five years. That would stimulate demand for new housing investment, eating up some excess savings. Adverse revenue impact would be more than compensated for by increased revenue flowing from greater economic activity.

While it is regrettable that the Japanese economy is not presently able to use all of the savings it can generate, given the internal and external constraints we have discussed, it is a fact and carries adverse consequences that must be managed. The rest of the world clearly has limits on how much Japanese goods it will accept in the form of excess Japanese savings, given local unemployment effects. Indeed, with the rapid rise in global interest rates due to the U.S. monetary and fiscal policies examined earlier, the debt-service burden of many countries has risen dramatically. To the extent that principal is usually rolled over, a rise in interest rates increases the effective debt-service burden. This development has put tremendous pressure on some countries (e.g., Korea, Mexico, and Brazil) to boost exports at a time when tight money has reduced the economic activity and demand of their traditional customers.

Unfortunately, these customers actually might wish to reduce imports as domestic protectionist pressures grow in response to reduced economic activity. For Japan to press on these markets at the present time because of its excessive saving rate is really irresponsible when the situation could be dealt with in positive ways. If the Japanese economy is to fulfill its potential beneficial role in the world, desired saving and investment policy must be brought more into line with existing needs.

Summary

Both U.S. and Japanese policymakers have had difficulty developing new arrangements for handling monetary and fiscal policy in an altered economic structure. It is this lack of new policy initiatives that bears
the primary responsibility for current trade problems. That is, each country developed a set of theories, policies, and institutional arrangements after World War II to deal with the immediate problems faced at that time. The U.S. had excess capacity and was concerned with underwriting and encouraging demand, particularly consumer and government demand. Economic policymakers reasoned that if demand were there, supply would take care of itself. Managing demand was thus the name of the game. Internationally, they wanted to rebuild the European and Japanese economies.

Conversely, Japan had a shortage of modern productive capacity. Yet to pay for food, raw materials, and energy imports, she needed competitive export industries. That requirement implied rapid non-inflationary growth based on manufacturing. The policy emphasis was placed, therefore, on saving, investment, and industrial evolution. The Japanese had little time and too few resources to be concerned with other countries' developments.

Both the U.S. and Japanese policies were probably appropriate when conceived. They became less so over time, especially by the early 1970s. Still, both nations have found it difficult to make appropriate policy adjustments: the U.S. to show more concern for domestic saving and investment; Japan to become less supply-oriented and more concerned with the well-being of trading partners.

Thus, not only does the U.S. need to adjust to a changed economic environment through higher saving rates, leading to lower inflation and interest rates, but Japan needs to adjust as well by lowering interest rates, substituting capital for oil, and bringing desired saving and investment into better balance. Otherwise the competitive interaction worldwide between an ever-weaker U.S. and an ever-stronger Japanese industrial base will become an increasingly explosive mixture. Both countries apparently face institutional obstacles to such changes. Relatively inexpensive but targeted policies in terms of budget imbalances are possible for both. It makes sense to seize this initiative.

question is one of joint will to overcome institutional and policy obstacles. The hope is that both nations can succeed.

NOTES

1. The issue of reexamining U.S. monetary and fiscal policy to deal with some of the structural changes in the economy is covered in more detail in William V. Rapp, "The United States and Japan: Competition in World Markets: Policy Alternatives for the United States," in Joint Economic


4. The relationship between debt, investment, growth, and pricing is analyzed in James Abegglen and William V. Rapp, op. cit.

5. For a discussion of Japanese consumer credit, see Japan Economic Institute, "Japan's Consumer Credit Market" (Washington, DC: Oct. 22, 1982).