Fragile Interdependence

Economic Issues in U.S.–Japanese Trade and Investment

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Japan’s Invisible Barriers to Trade

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Japan’s invisible barriers to trade, representing the full range of nontariff, nonquota practices and procedures, place foreign firms at a significant disadvantage in selling goods and services in the Japanese marketplace. Such practices have become a matter of considerable concern since the Tokyo Round of multilateral trade negotiations, with its focus on nontariff barriers to trade, combined with the growing Japanese trade surplus. Indeed, several studies over the past few years have reviewed these barriers in some detail. Thus, it makes little sense for me to retrace here ground covered by others. Therefore, I have catalogued in an appendix various concerns and complaints recently expressed by U.S. government policymakers and businesspeople and have indicated where detailed information addressing them can be found.

The historic levels of the U.S.–Japan bilateral deficit—$19 billion in 1983, over $30 billion in 1984, and perhaps as much as $40 billion in 1985—are a real cause for concern. This is particularly true given the narrow focus of Japan’s exports in sectors such as electronics, automobiles, machine tools, and steel. Therefore, legitimate complaints that Japan is perpetuating practices that discriminate against foreign firms can only lead to serious friction and adverse emotion. This disharmony then undermines and detracts from what is otherwise the United States’s most important bilateral relation, bar none, both economically and politically. These practices also can lead to global criticism of Japan being both the chief beneficiary of the world trading system and the least flexible nation in promoting trade as a two-way street.

Yet, Japan is the United States’s most important overseas market. In addition to $23 billion of U.S. exports in 1983 (more than our total exports to France, West Germany, and Italy, combined), U.S. firms sold about another $20 billion in goods produced by their Japanese subsidiaries and affiliates, plus an additional $5 to 10 billion imported from their investments in third countries. Japan is the United States’s best overseas market for agricultural products, with about 20 million acres planted for Japanese consumption alone. Japan is also the United States’s largest overseas market for beef (accounting for 64 percent of U.S. beef exports) and for coking coal. Japan is a
major market for U.S. manufactures as well, including chemicals, aircraft, photographic supplies, medical and scientific equipment, and pharmaceuticals. On top of that, the United States sold $10 billion in services. Nevertheless, as already noted, Japan sells an overwhelmingly larger amount to the United States than she buys, and the difference is growing. This realistically puts any discriminatory practices, both visible and invisible, under an expanding magnifying glass—especially if there is a big difference between U.S. and Japanese practices from which Japanese firms in the U.S. appear to benefit.

Countries running large balance-of-payments deficits with Japan and continuing to have relatively high unemployment rates (often very high in specific industries and regions) find it increasingly difficult to accept Japan’s need to protect certain industries from imports. Japan often defends its practices by citing the need to provide employment and avoid severe dislocations in labor markets, although the country’s overall unemployment rate is only 2.8 percent.\(^1\) This defense is, of course, most often heard in response to requests for tariff reductions or quota elimination in depressed or declining industries (for example paper, plywood, lumber, fabricated aluminum, polystyrene, beef, and citrus). But the defense is also raised with respect to certain nontariff barriers over a wide range of products and services such as chemical fertilizers, satellites, law, and computer software.

Unlike measuring tariffs or quotas, it is extremely difficult to estimate what the size of the market affected by these other practices is and, more importantly, what the impact of removing or adjusting barriers might be. It is for this reason that I consider in this chapter not only the range and variety of such practices, but also how the time-consuming process of changing even a few of these barriers has had a positive impact on imports and the ability of affected U.S. firms to sell in Japan. In addition, I shall try to quantify the size of some of the markets affected, so that the reader can understand why I and others involved in the exercise of reducing all Japanese trade barriers do not believe it is a trivial exercise involving around $2 billion in new imports from the United States, but rather an additional $10–15 billion in annual imports within about three years of implementation. Finally, major U.S. trade policy concerns of market access for all Japan’s trading partners and administrative transparency (clarity of administrative process and responsibility) are intimately involved with these trade-restricting practices.

Trade Barriers in Historical Perspective

As already noted, Japan is the chief beneficiary of the international trading system, with a projected global trade surplus in excess of $30 billion for fiscal 1984 and over $40 billion for fiscal 1985. Thus, it would naturally seem to be in Japan’s interest to do anything it can to maintain this free-trading system
and to avoid any practices that might undermine it. Indeed, given the visibility of its surpluses, it would seem important for Japan to avoid even the appearance of protectionism, much less its reality, so as not to justify such practices by others. This is especially so given that Japan’s current growth is still export-led, with direct and indirect effects on sales, employment, wages, and investment accounting for as much as 60 percent of growth.

Yet, the fact is that Japan still maintains several protectionist trade barriers that date back to a series of postwar industrial policies which targeted specific industries for development. These industries’ competitive development was, in turn, promoted by a combination of special loans, tax incentives, tariff protection, export incentives, limitations on foreign investment, foreign exchange controls, technology import controls, standards regulations, and so forth. While many of these practices have been dismantled, the active involvement of the government in numerous specific industries’ development has persisted. Furthermore, it must be recognized that actions or practices which restrict access to the Japanese market are in themselves a tremendous subsidy and incentive to Japanese producers. The very size and sophistication of the Japanese market means that preferential access both reduces investment risks and builds volume, hence increasing long-term competitiveness domestically and overseas. The longer this situation continues, the more experience and cash flow a Japanese producer gains which can be used both to defend Japanese market position and as a base to penetrate overseas markets.

Establishment of such competitive strength, in itself, then has an ongoing effect in the Japanese and world markets even if the particular practice or measure restricting market-access ends. If it continues, this enables the Japanese firm to concentrate its resources fully on overseas market development, with less concern for defending its domestic situation. This is why historically Japanese firms and products have almost always begun selling in the domestic market, only later exporting, first to less developed countries (LDCs) and later to developed countries.

For example, the government continues to feel a responsibility toward industries that it has promoted but which are no longer competitive. These are Japan’s depressed industries: more than twenty officially designated industries, over 50 percent of whose operating costs are related to energy and natural resources. These include aluminum smelting, chemical fertilizers, caustic soda, various petrochemicals, lumber, plywood, electric furnaces, and paper. Some (including fabricated aluminum, paper, plywood, and lumber) are protected from a large increase in imports by high tariffs. Others such as chemical fertilizers, however, seem import-resistant due to various legal arrangements, while apparent industry collusion safeguards soda ash, synthetic rubber, and caustic soda firms. The total Japanese market for such products exceeds $80 billion, yet with the exception of aluminum-ingot and
electric-furnace products, import penetration is surprisingly low, usually less than 6 or 7 percent.4

Historically, the whole purpose of industrial policy has been to promote the restructuring of Japan's economy and industry toward more sophisticated, higher-technology products, substituting government action for market forces, when the latter do not seem to be doing the job.5 In this regard, protection of depressed industries that in the past had been "favored children" is a rather new phenomenon. It reflects these industries' size and political clout as well as the slowdown in the Japanese economy which makes it more difficult to transfer resources to new emerging sectors. However, promotion of new emerging industries still remains very much a part of industrial policy, especially considering that these new industries have taken on an added importance given the maturity and decline of so many other sectors.

The Japanese government thus has active programs to promote such sectors as microelectronics, computers, software, telecommunications, biotechnology, new materials, space technology, and medical equipment. In many cases, such programs represent straightforward promotion via cooperative research funded by government and industry. While this practice may lead to the development of new products and new competitors, thus affecting world trade, such promotion of research is an accepted and legitimate role for government. The situation becomes somewhat cloudy in terms of market access and administrative transparency, however, if foreign firms or their subsidiaries are precluded from participating in such research, are not allowed to participate in the standards-setting process for new products in which they compete, have problems receiving patents in major new areas of development, are subject to potential technology loss given the operations of various institutional mechanisms, and are effectively restricted from access to certain key markets under the government procurement and budget process.

For many years, the Japanese government has worked closely with its leading firms to promote industry development and competitiveness. It is an accepted way of doing things in Japan. Close personal relationships in the pursuit of common objectives have naturally developed. Indeed, many ex-bureaucrats populate the higher ranks of the companies with whom they have dealt, and industry personnel often are loaned to related government agencies. Therefore, it is hardly surprising that over the years as industries have evolved, a wide range of industry and bureaucratic procedures have come into existence which promote and facilitate various sectors' development.

However, in general, foreign firms have been and continue to be excluded from this process. This creates the perception of exclusion from the market and does deny foreign firms timely access to information which may be important to their business and decision making. As I shall describe in detail later for some specific products and as can be seen in the appendix, in many cases this situation has indeed made it difficult for these firms to sell their
products in the marketplace. Japanese firms are, of course, not unaware of these factors, and so have some interest in seeing these conditions continue, at least in their own industries.

In order to address such access concerns on behalf of U.S. firms, over the last few years the U.S. government has made a concerted effort to increase the transparency of the Japanese government/business decision-making process and to have foreign firms participate in the process in areas such as standards, and industrial-structure and deliberation councils, to the extent these areas affect their particular business. In this manner, it might be said that the U.S. government has been trying to make the invisible barriers more visible.

At the same time, the U.S. government (USG) has been trying to have certain procedures and practices changed to improve U.S. firms' competitive access to the marketplace. These efforts have been both industry-specific (as in the case of semiconductors, telecommunications, software, chemical fertilizer, soda ash, optical fibers, cosmetics, beef, and aluminum baseball bats) and more general initiatives (standards, patents, industrial-structure-council participation, and customs procedures).

Yet, as has been pointed out by others, the Japanese "consensus" decision-making process can often operate as a "disconsensus" decision-making process. That is, if in the discussions an important party, one who must be included in the process, refuses to go along with a consensus, the others may have few mechanisms to compel him or her, so in effect, the person has a veto over the process. The stronger his or her interest and position, the stronger the veto. The upshot is that Japanese negotiations focused on changing a particular practice are difficult if one party has a strong interest in continuing it. To achieve change thus requires the use of substantial outside pressure to force a consensus, which partly explains the common and periodic escalation in U.S.-Japanese trade frictions. This escalation can then only be resolved at the highest policy levels as lower-level government officials are extremely reluctant to make a decision that might establish precedent.

The consensus that does eventually emerge is often the lowest denominator the recalcitrant member will agree to. Therefore the other party frequently finds the Japanese response slow and inadequate, especially given the time spent versus the result achieved. Further, if a particular group feels forced into agreement, it does not hesitate to try to put up new obstacles in the implementation phase. Under these conditions, it is hardly surprising that certain invisible barriers persist and are highly resistant to change. Nor is it surprising that achieving even the most minor changes for simple products can be quite time-consuming and will usually require ongoing monitoring to assure implementation. Indeed, every new trade package seems to have a surprising number of concessions which are repetitions of previous concessions (standards, for example). This is because every product has its industry interest group desirous of maintaining the status quo and of reducing competition,
foreign or otherwise. Indeed, the USG has often found that major beneficiaries of increased market access are Japanese suppliers previously excluded from the club—for example, the family of suppliers to Nippon Telephone and Telegraph (NTT).

Another contributing factor to resisting change seems to be the government's strong feeling of social responsibility for anything that happens, even a decision that was reasonable at the time it was made, was dictated by the market place, and was responsive to broad international concerns. So for example, the Ministry of Transportation still refuses to allow self-certification by U.S. auto producers, though the United States allows Japanese firms to do so. The feeling is that the Ministry, rather than the foreign firm, would be at fault if an error was made and an accident resulted. Similarly, the National Policy Agency will not approve the movement of loaded-high cube containers over Japanese highways, even though no accident occurred in the five years ending in 1984 during which their use was temporarily permitted; even though U.S. shippers are willing to restrict themselves to certain times and routes, and even though Japan is the world's largest manufacturer and exporter of such containers. The agency seems to feel that it would be blamed for any accident that might occur in the future.

However, explanations of the historical origins of various barriers to trade and why they seem to persist do not justify them in terms of Japan's current responsibilities to maintain and foster the international free-trading environment. Similarly, while every country has some trade barriers, the intent of the barriers and the willingness to find a solution to a problem once raised represent the essences of the negotiation framework that supports the international trading framework.

Unfortunately, Japan's basic resistance to regulatory or procedural change and the lack of transparency in the process often make Japan seem less than responsive in such negotiations. For that reason, it is important to firmly grasp some specific cases to understand the true nature of the barriers, the impact they have on trade, the irritations and frustrations they create, and the importance of moving more quickly to dismantle them in response to foreign concerns, not only from the United States but other countries as well. Thus the question I shall try to address is not whether the United States or Japan is more open in terms of tariffs or trade barriers, or whether Japan should import more manufactured goods than it currently does. Rather, the issue is whether Japan could appreciably reduce trade frictions, improve the current trade imbalance, and assist international trade by a dramatic change in negotiating posture and a real reduction in its present trade barriers. The answer I believe is a strong "yes!"

Case Studies in Invisible Barriers

The purpose of these studies is to give a more detailed picture of the realities behind Japan's image as a closed market, not only from the perspective of the
barriers themselves, but from the perspectives of the time-consuming negotiating process and required follow-up. These conditions apply to both very small and very large products in terms of overall trade. In this manner, I hope to give a bit of life to an otherwise rather dry listing of procedures and practices found in this chapter’s appendix. The case studies may also portray a bit of the frustration, irritation, and perhaps even the growing cynicism some foreign businesspeople or trade negotiators feel after dealing with the Japanese market, no matter how hard and how long they try. Further, while the USG’s general trade policy objective is to improve overall market access, the real negotiating world focuses on particular products, firms, industries, situations, and so on. So case studies in fact reflect the reality of trade policy implementation.

As the practices themselves cover a wide range of products, services, and industries, I have tried to select ones which indicate this situation and which represent important areas of policy, past and present. The major areas of current trade policy/market access concern for the United States are: (1) Japan’s depressed industries, an over $80-billion market in which import penetration is generally low,9 (2) a wide range of consumer and medium-technology products (food products, automobiles, leather, and sports equipment, for example) in which the United States has a particular advantage or know-how but market access is difficult due to standards, tariffs, or other barriers, and (3) high-technology products and services such as computers, computer software, telecommunications, biotechnology, and medical equipment.

Although I could give many other examples for each category, the case studies I have selected are (1) soda ash and urea chemical fertilizer, (2) aluminum baseball bats and standards reform, and (3) value-added networks, software registration, and communication satellites. These examples cover barriers ranging from legal monopsony to outright collusion, from compulsory technology transfer to local content requirements, and from bureaucratic red tape to outright discrimination against foreigners. Some involve objects of industrial policy; others do not. Some represent past obstacles, some current, some prospective.

Past and current problems are also seen to have lingering effects both in terms of competitive relations and market structure. In this sense such nontariff barriers can permanently bend comparative advantage toward Japanese firms. Thus, restrictions on investments by foreign firms in the semiconductor and pharmaceutical industries through the mid seventies, for example, created a permanent set of Japanese competitors whose domestic and global market shares are very different from what they would have been if foreign firms had been allowed to invest.10

Soda Ash

About 40 percent of Japan’s annual 1.2 million MT (metric ton) of soda ash production is inefficient. The inefficient Japanese producers make soda ash
from salt via electrolysis, an energy-intensive process in a high-cost energy environment. This means an annual 500,000 MT market opportunity for U.S. producers, the world's low-cost source. Yet, despite this, Japanese imports from the first oil crisis through 1980 never exceeded 70,000 tons per year, and in many years, Japanese exports actually exceeded imports, despite a thirty-five-fold increase in Japanese oil-based energy costs. Also most Japanese production inputs (such as salt, energy, and naphtha for ammonia) must be imported in any case. Indeed, Japan appeared to be the world's highest-cost producer in 1981. Further, its relatively lower-cost production technology was dependent on ammonium chloride sales which were declining. Delivered prices in Japan at 220 yen to the dollar were $250 to $290 per MT versus landed U.S. imports of $185 to $200 per MT ($175 to $190 if there were no tariff) as of September 1981. Yet imports remained low, and in 1981, U.S. firms approached the USG with the feeling that some illegal collusion might be involved to control imports.

The U.S. Department of Commerce (DOC) conducted a study that reached a number of conclusions. Despite the price advantage U.S. imports captured little of the soda ash market, only 5 percent (60,000 tons) in 1981. A number of observers believe that cooperation among Japanese producers and with MITI serves to limit U.S. access. The four soda ash producers work closely together in the Japan Soda Ash Industry Association, where they appear to reach agreements on production levels and prices. Through affiliated-company groupings called keiretsu, the Japanese producers are linked to the major trading companies that act as suppliers of raw materials and sales agents, and to other dealers that handle soda ash sales that are not channeled through the trading companies. With only four producers and few buyers, changes in the market are easy to recognize. Thus, the producers could quickly act against any distributor or user shifting toward imports, for instance, by threatening a loss of business or supply.

Furthermore, it seems that all imported soda ash is purchased by the Industry Association from the trading companies, and the Association then resells the soda ash at the prevailing Japanese prices. Particular trading companies are assigned to deal with specific U.S. exporters. Each exporter is assigned a quantity of imports into Japan, and in 1980 this was 12,000 tons from each of 5 U.S. producers. In addition, the seven Japanese trading companies earn the same profit, ¥20 million annually after expenses, even though they handle different volumes. The small amount of imports actually occurring may be tolerated to deflect foreign criticism.

Several U.S. producers have unsuccessfully attempted to expand sales by selling more to their assigned trading company, to another trading company, or directly to users, but they were told that "delicate relationships" would be upset. In one case the U.S. producer was told that the trading company would purchase more if the U.S. company could obtain the support of MITI.
Thus, the DOC study concluded that a form of cartel might be limiting imports of soda ash into Japan. The study recommended that the USG ask MITI to investigate the situation in order to ensure open and fair market access for all producers.

In addition, subsequent research revealed that because soda ash is a corrosive substance, it had to be imported via a certain dock, which was owned by the members of the Soda Ash Association. The availability of the dock and, in turn, of imports was directly controlled by this mechanism as well.

With this report in hand, the USG approached MITI, as recommended, to state its concerns on behalf of the U.S. industry. MITI said it would look into the matter, but later responded that it could find no evidence of collusion. Rather, it felt the issue was one of established supplier relations, the need for reliability of supply and local inventory, and internal distribution costs. Not satisfied with this response, the USG filed a complaint with the Japan Fair Trade Commission (JFTC) in 1982, which agreed to launch an investigation.

The JFTC’s conclusion was much different than MITI’s. After seizing and examining company records, it ruled there was an illegal cartel to control imports. Thus a cease and desist order was issued in March 1983, and U.S. imports began to rise, reaching about 140,000 MT in 1983, almost two-and-a-half times the previous import level.

However, the story did not end there. In early 1984, rumors began to circulate that the soda ash club was reorganizing to limit imports to 180,000 MT per year. Indeed, the chief executive of one of the major companies involved even boasted to the undersecretary of DOC at a dinner party how he was going to roll back the U.S. effort. This rollback appeared to consist of spreading misinformation among Japanese consumers about the nature of the U.S. companies forming a Webb-Pomerene export corporation. Japanese producers claimed the purpose was to restrict sales and raise prices once Japanese consumers became dependent on them. They also claimed MITI was supporting the reorganization of the club. To counter this tactic, the U.S. Embassy and the industry took the unusual step of publishing an article in the newspaper Nihon Keizai, while informing MITI and the JFTC of the reason and purpose of the statement. The JFTC also agreed to do a follow-up study to make sure the cartel had not reorganized.

The newspaper article explained that the Webb-Pomerene export corporation benefits Japanese customers by maintaining high-quality standards and reducing transport costs through rationalization. It detailed the cost advantage of U.S. soda ash, based on a natural production process using underground trona deposits, and how it is much less energy-intensive than the synthetic process used in Japan. Thus, Japanese users of soda ash, such as flat-glass manufacturers, could benefit from improved access to imported U.S. natural soda ash. The resulting improved penetration of Japanese and other markets is the goal of the Webb-Pomerene export corporation.
Hopefully this represents the last phase of the four-year USG/industry effort to open the Japanese soda ash market. Only time will tell. However, there will always be other restricted products. Recently, at the request of the Koreans and Taiwanese, the JFTC investigated and found the synthetic-rubber industry running an illegal import cartel. The JFTC is also investigating a possible flat-glass cartel, which perhaps indicates the ripple effect of high costs of inputs such as soda ash.

Chemical Fertilizer

Sales of all chemical fertilizers in Japan are controlled by a legal monopoly created by the Chemical Fertilizer Price Stabilization Law. Under this law, all fertilizer sales to Japanese farmers must be made through the National Federation of Agricultural Cooperative Associations (Zennoh), or its regional and local affiliates. In addition, once a year, Zennoh negotiates a price with the various producers which is approved and designated as the official price by the Japanese cabinet. In June 1984, over some farmers’ objection, this law was renewed for another five years.

Some fertilizers such as phosphates are presently imported since there are no duties or quotas on fertilizer sales. Indeed, the United States is a large supplier of phosphate fertilizers to Japan. However, in the case of urea, the Japanese manufacture their own from naphtha which they convert to ammonia and other nitrogen-based chemicals such as urea. Actually, Zennoh itself is a major producer. With the big price increase in oil and oil products (such as naphtha) during the 1970s, Japanese urea prices became very high by world standards, as reflected in domestic and export prices. Yet imports did not rise.

The U.S. DOC investigated the situation and reached the following conclusions. The Japanese urea industry was operating at about half of capacity in the early 1980s. The Japanese government issued a plan under the 1983 Structurally Depressed Industries Law to reduce capacity in the industry by 36 percent by 1986, but the plan made no provision for expanded imports, and, indeed, envisaged continued exports of urea from Japan. The lack of imports is surprising, since imported urea landed and bagged is quoted at $192 per MT, well below the Japanese ex factory price of $230 to $240 per MT. Furthermore, the high domestic price is necessary in order to offset losses on urea exports from Japan, priced at $195 per MT. There is apparently a consensus among Japanese government officials, urea manufacturers, and distributors to keep price-competitive imports out of Japan, and several U.S. firms have received “suggestions” that they not attempt to export more to Japan.

Imported urea accounted for less than 1 percent of Japanese consumption from 1980 to 1982 and less than 3 percent in 1983. Zennoh, which handles about 70 percent of the sale of chemical fertilizers in Japan, imports no urea.
Under the Fertilizer Price Stabilization Law, Zennoh and the Japanese fertilizer manufacturers fix the price at which Zennoh buys urea, subject to approval by MITI, MAFF (Ministry of Agriculture, Forestry, and Fisheries), and the Japanese cabinet. In addition, the remaining 30 percent of the market is supplied by manufacturers and importers who sell to local and regional cooperatives affiliated with Zennoh. Imports, although free to compete on price, have not achieved any noticeable penetration of the market.

Given this situation, the USG has actively pursued a policy to open the urea market. At first, it complained to MITI, which initially admitted that imports were restrained, but later claimed that the policy was due to the need for stability and reliability of supply. MITI also felt the cost of bulk handling and bagging (a requirement of Japanese small farms) also made up for a great deal of imports’ cost advantage. However, these explanations failed to account for either the low bagged-import price quote the U.S. government had received or the fact that Japanese production is dependent on imported naphtha, partly based on Midast oil imports, whereas fertilizer imports from the United States or Canada are based on natural gas located in a stable political environment. In addition, it did not explain the substantial difference between Japan’s bulk export price and bulk set factory price.

The USG then moved to try to have the Fertilizer Price Stabilization Law lapse. Some farmers, through their local cooperatives, also urged an end to the law. But MITI, MAFF, and Zennoh favored an extension of the law. They argued that self-restraint on urea imports is necessary to permit a restructuring of the Japanese urea industry. If the law is not continued, disorderly markets, with the danger of instability of supply, would result. In any case, they noted that the quantity of imported urea were increasing, and that imports already dominate the Japanese market for fertilizers based on potash and phosphate rock.

Of course the phosphate fertilizer point is a red herring and the import increase from less than 1 percent to less than 3 percent of the market is hardly a bonanza. Also, the long-term consequence for the farmers remains lower net real incomes. The result for Zennoh officials, however, is operation of their fertilizer plants. In any case, the law was renewed, a new high price for fertilizer was set, and imports remain minimal. Thus negotiation for market-opening continues. The next recourse may be to go to the cabinet; to not fix or approve a high fertilizer price, forcing more imports; or to go to the JFTC which still has jurisdiction if imports are being controlled. Yet the problem remains an important one. No apparent tariffs or quotas exist and the politically powerful farmers would appear to benefit from an expansion of imports. In addition, other ammonia products and exports appear to be supported by the artificially high domestic urea price. This cross-subsidization thus may affect imports of other ammonia-based products where Japanese costs would be less competitive if overheads and energy
costs could not be allocated to protected fertilizer sales. In any case, the market is closed.

Unfortunately this pattern, though the mechanisms are different, appear to extend to other depressed industries as well, such as petroleum refining and petrochemicals. Apparently for industrial policy purposes, Japan is discouraging imports in these sectors by tariffs, by sending missions to the Middle East, by selling production from offshore facilities (for example Sumitomo's petrochemical facilities in Singapore) in markets other than Japan, by administrative guidance (as in the gasoline industry), and so forth.

Japan's concern with this potential import penetration in turn seems to have a valid foundation despite oft heard remarks that full liberalization of all markets would only amount to $2 or 3 billion in increased trade. Between 1979 and 1983, imports rose from 37 percent of Japan's aluminum consumption to 83 percent. Ferro-silicon imports grew from 27 percent of the market to 65 percent. Methanol imports have now captured a full 100 percent of Japanese consumption, and Weyerhouser/Jujo's newsprint joint venture in California has gone from 0 to about 20 percent of Japan's newsprint market in a little over three years. So in commodity products such as soda ash, caustic soda, chemical fertilizer, plywood, lumber, petrochemicals, an gasoline, price-competitive imports can increase share and amount rapidly and significantly, if given a chance.

Naturally this is a trade opportunity for U.S. business and it creates policy questions for the USG. It also presents obvious difficulties to the Government of Japan (GOJ) and affected Japanese industries. The USG position is not to destroy such industries but to try to work out a mutually agreeable but transparent "soft landing," including possible U.S. investment in distribution and downstream fabrication. So far however, the Japanese have been relatively unresponsive to either change or alternative proposals. Where results do come, they may thus be more extreme, as in the case of methane or aluminum.

Aluminum Baseball Bats

In May 1983 changes were made in sixteen Japanese laws affecting standards and certification. This represents a landmark admission by the GOJ of how various bureaucratic and industry procedures can represent large barriers to trade for an extended period of time even in violation of international agreements. The U.S. DOC estimated more than $5 billion in annual trade was affected. Yet, the origin of this change was not in some large, critically important industry involving national policy and industrial strategies. Rather it involved the import of aluminum baseball bats. In this sense, the time, difficulty, and implementation problems involved are indicative of both the pervasiveness of these non-tariff barriers to trade and the way the Japanese system resists change.
Following a series of injuries resulting from defective metal bats in 1975, all metal baseball and softball bats were designated "specified products" under Japan's Consumer Product Safety Law. Thus, all metal bats sold in Japan would need to have the "S-mark" labels certifying product safety. The Japan Softball League (JSBB) also established standards for a "JSBB-mark" for metal bats used in league games. Although the JSBB standards were in fact based on the American product, U.S. metal bat manufacturers were refused certification by the JSBB when they requested it in 1980.

By the fall of 1981 the USG was negotiating with the GOJ to resolve the issue. The second package of market-opening measures, announced by the GOJ on May 28, 1982, contained a provision stating that any metal bat receiving an S-mark would also receive the JSBB-mark.

Yet this was not the end of the issue. There are various ways to assure that products meet safety and performance standards. One method is to inspect every item individually, but this is extremely expensive. Another way is to have manufacturers self-certify that their products meet the standards.

Japanese manufacturers may generally use self-certification. The factory, its production equipment, and its quality-control equipment are inspected and registered. This factory-registration and model-approval system allows the manufacturer to affix product-approval labels through self-certification. Annual inspections confirm the registration and approval. On occasion the government orders the factory to recall products or upgrade equipment.

Only Japanese factories are able to use the factory-registration and model-approval system, because foreign factories are beyond the jurisdiction of GOJ inspectors. Thus, imported products must use the lot-inspection system to certify compliance with standards and acquire the product-approval labels. A sample is selected from each shipment and tested. Only then can approval labels be placed on each item. In the case of baseball bats, until 1983 each bat was tested.

The lot-inspection system is an excellent nontariff barrier. It is time-consuming and costly, placing imported goods at a substantial disadvantage in competing with Japanese goods using the factory-registration and model-approval system.

Soon after the second package of market-opening measures was announced, a U.S. manufacturer requested the same treatment of factory registration and model approval accorded to Japanese manufacturers in order to avoid the expensive dockside inspections. This treatment was not granted.

Thus, the metal baseball bat case attracted attention to the operation of the Consumer Product Safety Law as a nontariff barrier. In August 1982 the USG used it as an example of discrimination against foreign imports and requested equal treatment for foreign suppliers under the law. Specifically, the USG argued that the lot-inspection system is a violation of the GATT Technical Standards Code that Japan had signed. Article 7 of the code requires
that foreign and domestic suppliers of similar products receive equal treatment under certification systems. Article 5 requires the same conditions of inspection for foreign and domestic products. When Japan signed the Code, the Japan Industrial Standards (JIS) law was revised to prevent discrimination against foreign suppliers. But somewhere in the Japanese bureaucracy actual customs procedures were established or maintained that restricted imports through an arbitrary and unreasonable certification system.

The baseball bat case points out another problem in trade relations—the lack of transparency in Japan's decision-making process. A clear process exists in the United States for dealing with trade issues. In Japan lower-level officials generally will not accept responsibility for establishing a precedent, and clear procedures often do not exist. Thus high-level officials of the two countries often must negotiate, even with respect to a product as seemingly unimportant as baseball bats.

Bilateral government consultations were held in early August 1982, the first step in reaching a settlement under the code procedures. When no settlement followed, the United States began formal procedures to submit the dispute to the GATT. Quickly a settlement was reached in late August 1982, whereby the Japanese government agreed to bring its laws and procedures into line with internationally accepted standards and practices for certifying imported products.

The United States and other countries requested that the Japanese government alter a number of its procedures toward technical standards. Foreign suppliers should be able to apply directly to the Japanese government for product approval. Certification systems available to Japanese suppliers should also be available to foreign suppliers. Foreigners should be able to participate in a more transparent process for establishing standards, and existing Japanese standard should be brought into conformity with international standards. Procedures for applying for and receiving product certification should be simplified and speeded up, and foreign testing agencies should be able to submit data to allow factory registration and model approval. Testing procedures should be clear and replicable, and the reasons for failure to receive certification should be disclosed to the applicant clearly and promptly.

In response to these requests by the USG, the Japanese government set up a special cabinet-level committee, the Gotoda Commission, under then Chief Cabinet Secretary Gotoda. The findings and recommendations of this commission essentially concurred with the U.S. position. As a result, sixteen laws were changed affecting almost as many Japanese ministries. However, it is the nature of Japanese law that implementation of the law is left primarily in the hands of the ministry involved through its controlling regulations. Therefore, the passing of sixteen laws did not end the problem or negotiation exercise as noted in the May 1984 trade package, which again promised movement on the standards
issue. Even the aluminum baseball bat case itself continued well into 1984 as MITI did not publish the standards application procedures, appoint the U.S. testing organization, and get U.S. factories registered until early 1984. In addition, while MITI had promised the USG that receiving the S-mark would mean automatic approval for the JSBB mark, in fact the JSBB tried to hold up its approval, attempting to require three years of testing in league games before granting its mark. Fortunately, this further obstacle was quickly squelched. Thus, Japan finally reached the stage of permitting the relatively free import of bats and allowing commercial interests to take over.

Unfortunately, the same progress has not been made concerning some other products. It was not until June 1984 that the first U.S. laboratory was authorized to do factory inspections (but still not product testing) under the electrical products safety law. Then in July, Underwriters Laboratory (UL) was approved under both the Electrical Products Safety Law and the Consumer Products Safety Law as a foreign-designated testing organization for both factories and products. However, initial factory inspections for JIS still remain outside UL’s responsibility, as do five other MITI standards laws. As yet neither UL or MITI have approved any U.S. factories. In addition, acceptance of foreign test data remains a problem in relation to several other ministries. By comparison, UL has forty-four inspectors in Japan and has approved five thousand Japanese factories.

Because of this situation, product-standard approval problems are still generally handled on a case-by-case basis, and each one can be as time-consuming and as difficult to solve as the aluminum baseball bat case. Problems span items as diverse as silicon dioxide in beer brewing, electrical connectors, vitamin E, and dogs’ flea collars. An alternative approach must be found if difficulties in this area are not again to be the source of substantial trade friction. This, in turn, means a more forthcoming and flexible administration and implementation of the Gotoda Commission’s recommendations.

**High-Technology Products**

Though value-added networks (VANs), software, and satellites involve three distinct negotiation problems with different ministries, products, barriers, and negotiation forums involved, they are all part of an important and complex interaction involving industrial policy, interministry competition, and long-term national strategic objectives. These are, in turn, all being visibly addressed at the highest levels of business and government on both sides of the Pacific. The resolution of the issues involved will heavily impact the future of U.S.–Japanese economic relations into the next century as they represent industries of the future where each country expects to play a leading role.
In recent joint industrial policy forums with the United States, Japan has maintained that the Japanese government no longer practices industrial policies that restrict imports or investment as ways of promoting domestic industries, and that it also no longer interferes with the transfer of technology by foreign firms into Japan. It further states that such policies were eliminated in the mid-1970s as part of its OECD obligations. Thus examples of restricted semiconductor investment or imports are behind us.

Immediately after receiving these open-market representations, however, the United States found active proposals by the GOJ to restrict to 50 percent foreign ownership of VANs (which are private telecommunication systems using leased lines over which special custom services are offered). Similarly, the GOJ refused to purchase U.S. or European communication and other satellites, ostensibly in order to protect domestic space science, but in reality to protect a very uncompetitive space capability. Finally, MITI tried to set up a new protection system for software other than the usual international copyright system. The new system would have allowed MITI to compel the transfer of U.S. software technology to Japanese firms on terms and conditions determined by MITI. The rationale was to help Japanese firms catch up with the United States in the area of software development, which is currently a U.S. competitive strength.

The U.S. government and industry reacted very strongly to this resuscitation of industrial targeting using the tools of restricted market-access. This negative response in turn had some success. The proposed foreign-ownership restriction was eliminated in the VAN legislation. But several onerous proposed regulatory provisions remained, especially for firms offering international VAN services. These concerns were still being hotly negotiated as of March 1985, more than a year after the initial discussions began and right up to the promulgation of the new regulations. Also, in conjunction with Japan’s Ministry of Education, the USG was able to persuade MITI to withdraw its proposed software bill. In addition, the purchase of communication satellites by private entities was liberalized as of April 1985. However, other kinds of satellites remain restricted, and NTT must continue to fund their current space satellite programs, reducing their incentive to switch to U.S. purchases. There is also the need to approve another band for satellite usage to facilitate the purchase of U.S. communication satellites. Thus, these high-technology trade issues are far from full resolution. Market access remains restricted and U.S. successes again illustrate that it is generally easier to prevent changes in procedures than to make changes in the existing system.

But more importantly, the fact remains that many of these new proposals and restrictions would never have been made if Japan were truly interested in opening the market in these new high-technology areas to foreign competition. One can't help but feel that the old attitude of industrial promotion via a range of nontariff restrictions remains strong. Of course, such barriers provide
valuable market support and reduce investment risks to Japanese producers, especially given the sophistication and size of the Japanese economy and its telecommunications system and the volume of system users. Also, without impacting the Japanese budget, such barriers represent a hidden tax on Japanese users to support the development of specific industries. Because they are hidden and are difficult to quantify, these restraints are particularly frustrating and onerous to foreign businesspeople and government negotiators who try to deal with them. Thus, they are handy industry support mechanisms in the hands of experienced Japanese bureaucrats. However, these practices, while well ingrained and persistent in Japan, are becoming extremely destabilizing to the U.S.–Japan relationship and the world trading system. Thus in terms of international relations, these regulations never should have been made.

Indeed, when combined with a ballooning trade surplus, such protectionist measures undermine Japan’s credibility as an open market and as a partner in the international trading system. This is especially true given the persistence of old barriers and the constant emergence of such barriers to trade as MITI’s control over gasoline imports, which was discovered recently in the case of Lion’s Oil.

The barriers in high technology are of course quite volatile issues on both sides of the Pacific because the United States and Japan see the future at stake as involving a large and significant amount of trade in both goods and services. The United States also feels the trade deficit gives it a right to compete in the Japanese market. Conversely, Japan’s declining industries and budget deficit put heavy pressures on their industry and government to find and develop new areas of economic activity without direct subsidies. Yet Japan has the expertise, technology, and economic strength to both compete and cooperate. This is the essence of comparative advantage. Both countries can succeed in different areas of each others’ high-technology markets. It is very much in Japan’s interest both as a trading nation and as a user of high technology to help this to happen, rather than to resist it. Otherwise its own high-tech users may not have access to the best and cheapest products they need. Unfortunately, Japan has not yet fully faced up to this reality, and its special interest groups have had their way via the “disconsensus” process.

Conclusions

These specific cases as well as many others noted in recent studies indicate that invisible trade barriers do exist in Japan. They affect a significant amount of trade, and because of industrial interconnections often give protection not only to the immediately affected industry or product but to related goods as well. Thus, fertilizer protection subsidizes the whole range of
nitrogen-based chemicals, while restrictions on gasoline imports lower the price of naphtha and fuel oil, helping the petrochemical and electric power companies as well as their users be more cost-competitive.

The U.S. government currently estimates that elimination of all current trade barriers, tariff as well as nontariff, would result in an increase of U.S. exports to Japan of between $10 and $15 billion annually within about three years. Given that other countries would increase their exports too, these barriers are not trivial. Their elimination could go a long way to reducing Japan's large trade surplus. Further, the case studies presented in this chapter are not rare exceptions to an otherwise fully open market. The very range of the examples noted in this chapter and its appendix testify to the diversity of problems encountered. Japan's strong interest in maintaining these barriers to protect domestic industries despite the international friction they create is another piece of evidence to their effectiveness. It took ten years of heavy negotiation over foreign cigarettes, as an example, to reduce tariffs, to expand retail outlets, to permit advertising, and to liberalize the distribution system.

Many Japanese still argue that these barriers are not material, but this does not appear to be the case. If it were true, why is there such strong resistance by Japanese firms to eliminating them to improve market access. A more pernicious argument to liberalization, however, is the recent one that liberalization would not change anything anyway even if imports did register a big increase. This is because macroeconomic forces would continue to force the transfer of capital from Japan to the United States and other countries, even though the product flow might be different.

While on the surface this argument appears plausible, deeper analysis reveals some logical flaws. That is, liberalization by increasing real imports would lower prices in Japan, increasing incomes and consumption. At the same time, many foreign industries that could expand exports to Japan generally have excess capacity. Thus, increased exports would generate jobs and taxes in the exporting country such as the United States, while lowering such costs as unemployment compensation. In effect, liberalization would make global capital-utilization more efficient, raising world incomes. Thus liberalization would reduce excess saving in Japan while raising savings rates in the United States and elsewhere. Therefore, the macro-effects of liberalization would also work to lower the trade deficit. Again, improving market-access is not a fruitless exercise.

To get at individual trade barriers, however, requires detailed information and industry-government persistence. Both these factors would be materially aided by improved transparency in the regulatory process. Foreign firms' participation in the various industrial-structure and standards-setting councils would be one way to do this. However, GOJ resistance to this development has been strong, though some small progress has been made in
certain areas. Much of this resistance reflects natural bureaucratic reluctance to change. In part, it also reflects the very great changes going on within the Japanese economy and the competitive pressures on Japanese firms to restructure. Many Japanese firms are thus not confident about their ability to withstand real foreign competition in their domestic market.

Nevertheless, as the trade deficit grows and the Japanese market becomes more visible, such liberalization must occur or international tensions and pressures will rise to crisis proportions. Japanese policymakers often may see themselves as acting on behalf of domestic interests and try to explain this motive to foreigners seeking to gain their mutual understanding. Still these Japanese officials need to become more sympathetic to the views and frustrations of foreigners as well since it is these foreigners who will ultimately determine the terms on which Japan will have continued access to their markets. Continuing to ignore their interests will result in more actions such as the 1984 Trade Act or the recent Thai countertrade proposals. Under the 1984 Trade Act, the President was given the power to order retaliation against countries found to be using restrictive foreign trade practices harmful to U.S. interests. The Thai countertrade proposals link increases in Japanese exports to Thailand to commensurate increases in Thai exports to Japan, particularly in products whose export is being promoted by the Thai government. These actions are clear signals of a growing philosophy of reciprocity as a guiding principle in international trade. Japan is thus very much affecting its own future, and its invisible trade barriers are playing a more and more visible role.
Appendix: 
Generic and Industry-Specific 
Invisible Barriers to Trade

As already noted in this chapter, several studies over the past few years have detailed the complaints of foreign businessmen in Japan. The result of this increased transparency of trade barriers, combined with pressure from foreign governments, has been the reduction and elimination of some practices. However, several remain and are listed below by both general area and specific industry. There has been no attempt to eliminate overlap between the categories. However, it should be noted that when the same problem appears in more than one sector, it indicates that it is a particularly difficult problem for a specific industry as well as more generally for several products. Also no attempt has been made to try to differentiate between barriers to trade and investment, as investment is considered a key contributor to facilitating imports into Japan and to improving a firm's competitive position.

I have only referred to barriers such as language or the distribution system when government action could ameliorate the situation. Otherwise they are an innate part of the environment which will just have to be dealt with.

Reports


**Invisible Barriers to Trade**

*General Measures*

Generic problems affecting a broad range of goods and services.

1. *Standards code:* Japan has passed sixteen laws to permit more foreign participation in the standards-setting process, and it seems to comply with international procedures on prior notification in creating or revising standards. However, Japanese ministries still do not have a procedure for accepting foreign test data in many areas, including Japanese industrial standards, pharmaceuticals, and medical equipment. Only two U.S. firms have been designated as foreign testing organizations, and none can do the initial tests for JIS marks. Self-certification also remains elusive, particularly in areas such as automobiles. Thus, five years after this problem was first raised as a nontariff barrier, and two years after sixteen laws were passed to achieve needed changes and a Japanese cabinet-level commission recommended such significant if not sweeping changes, there is still very little effective implementation of improvement. Indeed, in areas such as telecommunications, foreign firms have so far not been granted access to the ministry’s deliberative council in which standards are discussed and set, even though Japanese law now requires such participation for industry-association-standards advisory committees. Thus standards issues remain an important impediment to increased imports. (See reports 1, 5, and 7.)

2. *Customs-valuation code:* The problem of uplifting assessment valuations in related-company transactions (transactions in which goods move between company offices) is one of raised duties and discouraged imports. Similarly, costly clearance delays could be significantly reduced by permitting the increased use of bonded warehouses, publishing clearer
customs procedures, allowing goods to clear customs on bond with subsequent settling of duty payments, eliminating various permit systems, and clarifying the fees involved. Also there is no customs-duty drawback provision when a product is reexported.

3. **Establishment of a transparent import-licensing code**: GOJ has not taken action to comply with or implement such a code despite provisions in the amended 1980 Foreign Exchange and Trade Control Law. Import restrictions are added or deleted by administrative guidance, and import-quota allocations are not transparent. Thus all applicants do not have an equal chance to compete. As some quotas are not fully utilized, this is an area of some concern, as is the introduction of administration practices without due process.

4. **Government-procurement code**: Japan has conformed to the letter of the GATT code, especially in establishing transparent procedures for government procurement. However, the extensive, almost exclusive use of sole-source tendering (which was originally intended for exceptional circumstances) has almost vitiated the code’s intent in terms of opening the Japanese government-procurement market. In addition, some administrative obstacles remain, such as the thirty-day minimum notice period which is the Japanese maximum and which permits little time for translation and bid response. (See reports 1, 4, and 7.)

5. **Intellectual property**: Inventions, brand names, corporate symbols, product styling, proprietary know-how, and so on are highly valuable assets to any corporation. However, with respect to Japan, they are often the only entry advantage to a potential foreign exporter or investor into Japan. Thus, protecting that advantage becomes a critical part of any market-entry or market-development strategy. Therefore, the net impact of Japan’s administration, laws, and procedures in the area of patents, trademarks, and copyrights has had a material and, unfortunately, generally adverse impact on foreign firms’ competitive position in Japan.

   The large number of applications combine with the Patent Office’s limited resources to create the biggest problem concerning intellectual property. There are four times as many patent filings as in the U.S., and applications can take four to six years to be processed. As patent applications are open for public inspection after eighteen months, and the patent period runs from the application date, such delay substantially reduces the period of protection, and, more importantly, opens an importer or investor to potential technology loss during the critical initial market-development period. This situation can and does discourage both trade and investment.

   In addition, the ability of Japanese firms (often those which have subsequently developed a similar technology) to object to a patent grant
before the patent is finally authorized, combined with their ability to borrow the patent file, can cause even greater delays. Further, potential patent infringement and the winding down of the potential-protection clock continues. The Japan Patent Office also does not offer foreign firms sufficient time to file applications based on their overseas patents, given the problems of translation. Also the Patent Office rejects applications for minor errors of commission or omission, rather than granting an extension, to revise the application.

Trademarks offer a similar area of concern, given long delays, the ability of Japanese firms to register foreign trademarks in Japan, and the difficulty in renewal if minor changes have been made. Also, Japan's trademark protection does not extend to servicemarks. And there is no protection in Japan for trade secrets or industrial know-how. (See reports 3, 4, and 7.)

6. Academic discounts: These discounts are a specialized form of market promotion aided by a provision in the tax code that permits the difference between a product's list price and its sale price to an educational institution to be deducted for tax purposes. Depending on the list price and a company's marginal tax rate, the practice may permit a firm to sell at a profit due to an effective tax subsidy, even when the discounted sale price is below cost. Furthermore, the Ministry of Education often uses the existence of academic discounts to justify sole-source tenders, even though the source of the discount is still coming from government funds via reduced tax revenues. As local earnings are needed to take advantage of the tax provision and the pool is limited to a percentage of earnings, the effect is to favor large Japanese companies at the expense of importers. This discount is an especially important advantage in selling such items as super-computers and expensive medical equipment to university laboratories and hospitals. Such sales in turn can establish a strong market position for Japanese firms in these high-technology, innovative products.

Industry-Specific Measures

Industry-specific measures affecting foreign sales of goods and services are often but not always involved in issues of industrial policy. In these cases, market-opening measures become intertwined with issues of fairness, long-term government objectives, and targeting changes in comparative advantage. I shall try to distinguish in the following list between those areas where barriers are considered part of Japan's industrial policy objectives and areas where barriers are more the result of historical accident. The former are marked with an asterisk.
* 1. Banking and securities: See reports 2, 3, 5, and 7.
* 2. Energy: See reports 2 and 3.
* 3. Chemicals: See reports 2, 3, and 7.
* 4. Pharmaceuticals and medical equipment: See reports 2, 3, and 7.
  5. Construction/engineering firms: See reports 2 and 3.
* 6. Depressed industries: See reports 1 and 7.
* 7. Telecommunications products and services: See reports 1, 3, and 7.
  11. Insurance: See reports 2, 3, and 7.
  13. Transportation: See reports 2, 3, and 7.
*17. Forest products: See reports 5 and 7.
  20. Legal services: See reports 3 and 7.

Notes

1. While Japan's overall unemployment rate is 2.8 percent, the unemployment rate among people below age 24 is running at 5.6 percent. (Note that to be considered employed in Japan one need only be working a few hours per week.) Also, certain regions such as Tohoku and Hokuriku that have been dependent on now depressed industries such as aluminum are now suffering especially high unemployment rates. Also, the national job-to-applicant ratio remains about 0.6. Despite these conditions, the 15 to 35 percent unemployment rate in parts of the United States has no equal in Japan.


5. See footnote 2 above.

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7. For similar comments by an ASEAN official, see Norongchai Akrasanee, "Japanese Obstacles to Trade: A View From Asean" Speaking of Japan, (September 1984):4–8.

8. Japan imports fewer manufactured goods than other developed countries. Gary Saxonhouse has analyzed this in “The Micro- and Macro-Economics of Foreign Sales to Japan” in Trade Policy in the 1980s, ed. William R. Cline (Washington, D.C.: Institute for International Economics, 1983). He concludes that econometrically this import pattern can be explained by the apparent structure of Japan’s economy. However, if there are obstacles to trade in certain goods with large internal markets where imports would increase in the absence of these obstacles, the relevant reality that Japan must address is these obstacles and not the question of comparative statistics.


10. This point has been made in several recent studies including those by the Japan–U.S. Businessmen’s Conference and the Advisory Council on Japan–U.S. Economic Relations which are cited in the appendix.

11. Good background discussions of these three issues are found in U.S.–Japan Trade Study Group, op. cit., pp. 9–10, 56. Also see works by Japan–U.S. Businessmen’s Conference and Advisory Council on Japan–U.S. Economic Relations cited in the appendix.

Comment

Seiichiro Ohtsuka

The topic of invisible barriers to trade, otherwise known as nontariff barriers, reminds me of a remark made by Prime Minister Nakasone during his visit to New York in May 1983. Appearing at the Japan Society's annual dinner, Mr. Nakasone made his speech in English, which is rare for a Japanese prime minister. At the outset of the speech, he commented, “Although my feet tremble a little bit, I will try to speak in the English language, which for us Japanese is a serious nontariff barrier.” The audience enjoyed a good laugh and Mr. Nakasone earned a front-page photo story in the New York Times for his successful effort to cross this invisible but difficult barrier.

My objectives in this comment will be to put the issue of Japanese barriers to imports in perspective; explain recent Japanese efforts to improve further the access of imports to our markets; examine the cultural dimension of the nontariff barrier issue; and look at some specific cases in which nontariff barriers have been removed.

Putting the Issues in Perspective

There are three basic kinds of barriers to trade—quotas, tariffs, and nontariff barriers. I will examine each of these separately in order to put Japan's performance in perspective.

Twenty-three years ago, in 1962, Japan had as many as 493 import-restriction quotas. During these past two decades, though, Japan has drastically reduced the number of quotas it maintains. Now there remain only 27, a number that compares quite favorably with France's 46, Italy's 38, and West Germany's 14. The United States itself currently maintains import quotas on 20 items, including import restrictions on 13 farm products under an original waiver from GATT. And in the industrial sector Japan retains only five quotas, while in France there are 27 and in the United States, six. Hence, it is reasonable to conclude that the United States and Japan are more or less equal on the issue of quotas.
As for tariffs, Japan alone among the major trading nations has been scheduling unilateral tariff reductions. Since December 1981, Japan has dropped tariffs by an average of 16 percent on 1,653 items, representing about 60 percent of all Japanese tariffs. Subsequently, Japan's average tariff level today of 3.2 percent is actually lower than that of the United States or the European Community. And by 1987, when tariff reductions agreed upon at the Tokyo Round of multilateral trade negotiations are fully implemented, average Japanese tariffs will amount to 3 percent of the value of imported goods, compared with 4 percent for the United States and the European Community's 5 percent.

It is true that Japan maintains high tariffs in certain categories, but this is no less true of the United States. For example, Japan maintains a 68 percent tariff on whiskey and an 18.8 percent tariff on plywood. Meanwhile, the United States imposes high tariffs on such items as textiles (42 to 57 percent) and chinaware (54 percent). To put the issue of tariffs into a better perspective, perhaps one should consider the ratio of revenues from duties levied to the total value of imports. Japan's rate of 2.5 percent is the lowest of any major industrialized country, lower than that of Australia (9 percent), Canada (4.5 percent), the United States (3.2 percent), and the European Community (2.6 percent).

Turning to nontariff barriers, I would emphasize the importance of maintaining a sense of proportion when considering this issue. One case in which this sense has been seriously lacking is seen in the debate over Japan's beef and citrus imports. Japanese imports of these two products have become a highly politicized issue and a symbol of Japan's allegedly closed market. Yet while Americans complain that Japan does not buy enough beef from the United States, fully 64 percent of U.S. beef exports have been flowing into Japan. This plain fact rarely comes across to Americans.

Another fact seldom brought to light is that beef constitutes only 0.4 percent of Japan's total imports and only 0.1 percent of total U.S. exports to Japan. Evidently we are not viewing this issue with a proper sense of proportion. This situation arises partly because we do not dig into basic facts and figures for ourselves and also because the media do not report all of the facts. As a result, we have a perception problem. And the "beef and citrus war" goes on.

There is no question that beef and citrus quotas are an important issue. They require our attention and should be resolved by mutual accommodation. In the meantime, though, we should take care not to allow politicization of this issue to distort our sense of perspective.

The same could be said about the issue of nontariff barriers. They, too, create a significant issue but as a result of politicization, the nontariff-barrier issue has been blown out of proportion by excessive media attention. As a result, the yardstick for judgment often has been blurred. Nothing could be
more unfortunate and harmful than the diagnosis of the disease called “nontariff barrier” becoming worse than the disease itself.

Japan's Record of Improvement

What is Japan’s record of performance in the area of nontariff barriers?

Since 1982 the Japanese government has taken a series of major initiatives for market-opening and deregulation. The improvement and simplification of standards and certification has been one of the top priority items. In January 1983, Prime Minister Nakasone initiated a vigorous review of the existing standards and certification system, taking the concerns of Japan’s trading partners into full consideration. Nearly twenty existing laws were amended and important legal changes were made in five major areas with the goals of (1) ensuring nondiscrimination between nationals and non-nationals in certification procedures, (2) ensuring transparency of standards, (3) promoting internationalization of standards, (4) promoting the acceptance of foreign test data, and (5) simplifying and speeding up certification procedures.

Looking at these five areas in a bit more detail, let us consider the issue of nondiscrimination. Japan is a contracting party of the GATT standards code agreement on technical barriers to trade, which came into effect in January 1980. To ensure that the legal system allows no discrimination between nationals and nonnationals in Japan’s certification procedures, nearly twenty laws have been amended including the Pharmaceutical Affairs Law, Agricultural Chemicals Regulation Law, and Consumer Product Safety Law. These amendments will (1) enable foreign suppliers to apply for and obtain certification directly, and (2) treat foreign products and suppliers equally with domestic products and suppliers with respect to testing methods. Thus, these amendments will enable foreign manufacturers who wish to enter the Japanese market to have the choice between applying directly to Japanese certification systems and applying, as before, through importers in Japan.

I should emphasize that only a few of the standards code's other contracting parties (such as the United States) grant foreign manufacturers direct access across the board to their certification systems. These amendments have made Japan’s certification system one of the most open in terms of legal systems.

Transparency of standards and certification procedures is another issue often raised by interested foreign parties, who assert that it is difficult to know precisely when and under what procedures various Japanese standards are drafted. Also, it has been pointed out that it is necessary to have foreign practice and views reflected fully in the standards-drafting processes.

To deal with this problem, there have been significant developments in three areas. First, opportunities have been expanded to hear the opinions of
all parties concerned, including foreign nationals, from the outset of the standards-drafting process. (On this point, although the case does not directly involve standards-drafting, it should be noted that on October 30, 1984 a U.S. businessman, Robert L. Sharp, president of the American Chamber of Commerce in Japan, became the first American to testify before a meeting of the Industrial Structure Council of Japan, a rather historic development.)

Second, the Japanese government has recently compiled and published a 400-page directory of standards-drafting and standards-revising processes written in both English and Japanese. It is a highly technical book but an immensely useful one. It explains twenty-five Japanese laws concerning standard and certification systems, providing for as many as 115 items an outline of specifications and standards, procedures for the establishment and amendment of specifications and standards, and so forth.

Third, in January 1982, the Japanese government established the Office of Trade and Investment Ombudsman (OTO) to facilitate the prompt and accurate processing of complaints regarding import-testing procedures and related issues. As of June 26, 1984, 155 complaints had been received. Of these, 143 have already been processed. Improvements resulted in 41 cases, and misunderstandings were cleared up in another 69 cases. In 44 cases, because of the help of the OTO, imports were promoted.

In the area of conformity with international standards, Japan has promptly moved to bring Japanese standards into line with existing internationally accepted standards. For example, recently it adopted IEC (International Electro-Technical Commission) standards for household electrical appliances and ISO (International Organization for Standardization) standards for motorcycle helmets. Also, beginning in October 1983, Japan relaxed its safety standards for automotive headlights.

Japan has also begun accepting product-test results from reliable foreign sources, an area of great significance in simplifying the regulatory testing process and in facilitating the flow of goods. In October 1983, Japan began accepting preclinical-stability-test and methodology data for pharmaceutical products based on the work of foreign testing organizations. Japan has also begun to accept foreign test data on chemical substances, based on Good Laboratory Practice standards.

Finally, Japan further simplified and accelerated import-certification procedures. For example, test results, documentation, and other requirements for imported automobile type-certification were remarkably simplified, thereby reducing the present notification system from about seven months to 2.5 months. Other steps have been taken to simplify animal- and plant-guarantee requirements, and, for pharmaceuticals and electric appliances, to ease restrictions on the transfer of import-type approvals between importers where the foreign manufacturer remains the same.
How does the U.S. government view all of these efforts by the Japanese government? In May 1983, after the Japanese parliament enacted one of the most important series of market-opening measures, U.S. Trade Representative Bill Brock said, “The action taken by the Japanese Diet represents the most significant development in our bilateral trading relationship since the conclusion of the Tokyo Round of multilateral trade negotiations.”

What Is Really a Nontariff Barrier?

Sometimes what foreigners perceive at first glance to be a nontariff barrier happens to be in reality an entirely reasonable and legitimate form of regulation. Each country has its own system of standards and certification procedures deeply rooted in its traditions, social customs, and the role of government within that country. Standards and certification systems are established and enforced in order to protect human lives and health, consumer interests, and the environment. They are not intended to intentionally exclude imports or discriminate against foreign products.

If, however, specifications and standards are unnecessarily more rigid or strict than those widely adopted in other countries, the net result can be tantamount to impeding imports from abroad. In particular, if the certification systems based on standard and testing procedures are unreasonably strict for imports, the net results can be serious.

Let us consider Japan’s automobile-safety regulations as a form of nontariff barrier. I choose this subject because there are certain important systemic differences between the way we regulate auto safety in Japan and the way it is done in the United States. To protect the public, the Japanese government conducts tests and inspections of automobiles prior to their release in the market. The U.S. government has been requesting that the Japanese government allow U.S. auto manufacturers to self-certify compliance with Japanese safety regulations as U.S. auto makers do with U.S. regulations.

However, the Japanese system has long been based on the idea that all possible precautions should be taken to minimize injuries. I am sure you will appreciate the meticulous zeal the Japanese demonstrate on this issue if you consider the situation in Japan—where no less than one-half the size of the entire U.S. population and 40 million automobiles are packed in an area roughly as large as Connecticut. In Japan, if people were to learn in the newspaper one morning that half a million cars of a certain type had to be recalled because some mechanical defects had been found, there would be an uproar.

Nonetheless, in response to the U.S. request, the Japanese government has drastically simplified its type-designation system for automobiles. The
new type-designation system no longer requires inspection of each imported vehicle at the land transportation office. It should also be pointed out that while the U.S. government allows self-certification with respect to safety and noise standards, it maintains an inspection and testing system for emissions standards, and some twenty U.S. states maintain compulsory safety or emissions tests of their own. In addition, most European countries have pre-inspection systems similar to Japan’s.

Specific Issues

I now turn to specific import items which have become troublesome in U.S.–Japanese trade relations—soda ash, aluminum baseball bats, and value-added networks.

Soda Ash

In the case of soda ash, there was an outright collusion by Japanese firms in violation of Japan’s Antimonopoly Act. Japan’s Fair Trade Commission acted to enforce the law. Subsequently, imports of natural soda ash from the United States to Japan rose more than three-fold from 64,000 tons in 1981 to 212,000 tons in 1983.

Aluminum Baseball Bats

Some months ago aluminum baseball bats became a symbol of Japan’s non-tariff barriers. Many Americans must have thought, “If the Japanese have been so successful in importing the American game of baseball, why can’t they import our baseball bats?” To make a long story short, basically the problem has been resolved. Three U.S. companies (Easton, Worth, and H&B) have already taken concrete steps to take advantage of the simplified system. Worth Company obtained the “S-mark” approval in August 1983, and one thousand bats per month on average have been imported since then.

Value-Added Networks

The VAN issue is a good example of how through sophisticated, quiet diplomacy the United States and Japan were able to detect and resolve a problem in its emerging stage. The United States voiced its objection to a Japanese proposal, and Japan responded before the problem had developed into a divisive issue. This is a case of early-warning and early-response systems operating at peak efficiency.

In late 1983 and early 1984 the Japanese cabinet was preparing legislative proposals dealing with new telecommunications technologies, including what
the Japanese call VAN, or value-added network service—something equivalent to enhanced telecommunication service in the United States. During the course of these cabinet discussions, one of the ministries floated the idea of limiting the ratio of foreign capital, and thereby limiting foreign access, in a certain category of telecommunication service operating through a leased communication trunkline.

The issue was resolved by the U.S. government and U.S. companies in Japan, which clearly and quickly voiced their objections to the ministerial proposal before it had even won the support of the Japanese cabinet. As a result, the Japanese government drafted and enacted legislation effective in 1985 that eliminates any discriminatory treatment. To start up a VAN business, notification or registration is required, depending on the size of the business. The original idea of a licensing system has been dropped. There is no discrimination against foreign capital. In addition, the legislation clarifies the requirements for notification and registration to ensure transparency. The door is open wide to foreign companies interested in the Japanese telecommunication market.

The VAN issue is a case of the early-warning and early-response system operating at peak efficiency. The United States and Japan must continue to cultivate this kind of practical wisdom for their mutual interest.

Conclusions

The Japanese market-access problem has become the focus of much controversy in U.S.-Japan economic relations. But people should not forget that the United States also has barriers to market access. According to an estimate by the Center for the Study of American Business at Washington University, U.S. barriers amounted to a hidden tax of about $58 billion, or $2.55 per American consumer, annually. Another recent study, conducted by the Institute for International Economics in Washington, finds that U.S. nontariff barriers affect 34 percent of the U.S. market for manufactured goods, compared with 7 percent in Japan, 10 percent in Canada, 20 percent in West Germany, and 32 percent in France.

U.S. barriers, for example, include federal and state “buy American” statutes, shipping restrictions on goods purchased using U.S. foreign aid, the limitation of commerce between U.S. ports to U.S.-built ships, restrictions on agricultural trade (both federal and state), and high tariffs on some items (such as certain chemicals, textiles, ceramic products, vegetables, and fruit juices), and the unitary tax system in the investment sector.

Neither Japan nor the United States can claim its market is entirely free of impediments to market access. To reach this goal the two nations must continue to work together to reduce market barriers and strengthen the free and open world trading system.
The nontariff barriers that do exist in Japan should not be interpreted as evidence of a perfidious, insincere, or self-serving trade policy. Like any nation, Japan has its free-traders and its protectionists inside the bureaucracy, inside industry, and inside the political establishment. They are waging the same battles for control of policy, in essence, that are waged in and outside Washington.

Lastly, let me summarize Japan’s record of performance.

Japan is the only country in recent years which has moved unilaterally in market-opening measures, reducing quotas, cutting tariffs, and eliminating nontariff barriers while other countries have been moving in the opposite direction, erecting new barriers.

Vis-à-vis the United States, more than half of Japanese exports to the United States are currently under a restraint program of one kind or another. This includes automobiles, textiles, and steel.

Japan is the only country among the contracting parties to the GATT standard code which has taken steps to improve its standards and certification system as a whole.

As my final and perhaps most important point, let me add that Japan’s market is highly competitive. Vigorous market-opening efforts by Japan should be matched with equally vigorous market-penetration efforts by U.S. companies. The recent U.S. efforts on this front are becoming more vigorous and they are beginning to bear fruit. These are encouraging signs.

The fact is that U.S. exports to Japan have been steadily increasing while U.S. exports to the rest of the world have been declining. Between 1981 and 1983, U.S. exports to Latin America declined by nearly 40 percent and those to Western Europe by more than 16 percent. However, U.S. exports to Japan in 1983 rose 5 percent. And during the first seven months of 1984, U.S. exports to Japan were up about 15 percent from the same period of the previous year. This growth rate is nearly three times faster than that of U.S. exports to the rest of the world—and this is happening despite the overvaluation of the dollar. In the first seven months of 1984, U.S. specialized machinery shipments to Japan were up by 49 percent, telecommunications equipment by 48 percent, and computers by 26 percent.

I do not claim that there are no serious problems on the Japanese side in the area of nontariff barriers. But it is clear that where there are problems, Japan has been tackling them positively and forthrightly, producing concrete and visible improvement on many fronts. Japan’s actions and the facts speak for themselves.
Japan’s bilateral surplus in merchandise trade with the United States is bigger now than ever before and widely expected to keep right on growing. This bilateral trade imbalance provides the customary justification for perennial U.S. efforts to negotiate reductions in Japanese barriers to imports, especially to imports from the United States. Resulting liberalization measures are predictably hailed for their anticipated contribution to narrowing the U.S.-Japan trade gap. Subsequent growth rather than shrinkage of the bilateral imbalance is then taken as evidence of the insidiousness of Japan’s invisible barriers to imports, and perhaps also of the obstinacy and bad faith of the Japanese.

The trade surpluses are undisputed fact, and at least some nontransparent import barriers are fact also, although their existence is hardly unique to Japan. The problem lies in the assumed causal link between trade barriers at the product or industry level and aggregate trade performance as measured by the merchandise trade balance, with the corollary prediction that “real” liberalization will necessarily reduce the bilateral imbalance.

Underlying this view, which dominates both official and private U.S. thinking on trade with Japan, is a basic misunderstanding of the determinants of aggregate trade performance and of the gains from trade liberalization. The misunderstanding in turn leads to inevitable disappointment with the results of negotiations. Frictions escalate, and opportunities for mutual benefit are wasted. By doing the right thing for the wrong reason, U.S. negotiators set up unrealistic expectations and thereby fan the flames of protectionism.

In what follows, I argue that the current U.S. deficit on merchandise trade with Japan—the most frequently cited “evidence” of pervasive Japanese barriers to imports—is largely determined by the strength of the U.S. capital account, which in turn reflects macroeconomic influences only remotely linked

This material was prepared while the author was a visiting scholar at the Hoover Institution, Stanford University.
to trade performance at the industry level. As a consequence, Japanese market-opening measures, even when well intentioned and scrupulously enforced, can have little effect on this aggregate.

Yet this does not mean that efforts to open the Japanese market should be abandoned. On the contrary, trade liberalization (on the part of the United States as well as of Japan) is an important means to promote increased gains from trade for both partners, by allowing the expansion of both imports and exports along lines of comparative advantage. Acknowledging the true nature of the gains from trade liberalization ensures a negotiation process that is sustainable and mutually beneficial, rather than a cycle of reluctant acquiescence and subsequent recrimination.

Japan's Invisible Barriers

Dismantling Japanese trade barriers is often compared to peeling the layers of an onion. William Rapp's chapter, especially the detailed documentation in the case studies, indicates just how apt that metaphor is. Although Rapp relies on case studies to make his point, a systematic review of the “major” market-opening measures announced by Japanese officials over the past decade conveys the same clear message: any given barrier must be tackled over and over before progress becomes evident in actual transactions. The cases Rapp cites are thus not isolated instances but representative of a broader phenomenon. On the other hand, Rapp also acknowledges huge increases in import penetration in a number of industries, suggesting that the characterization of the entire Japanese market as closed to imports is inappropriate. Rather, the problem of import barriers is primarily a sectoral one.

The case studies emphasize that combatting any particular barrier entails considerable U.S. government effort and resources. This implies the need to decide which barriers are most important to the United States. How should U.S. officials allocate their negotiating efforts across industries and across trading partners? Rapp clearly believes that the large bilateral imbalance with Japan by itself justifies a high priority for U.S.–Japanese bilateral negotiations. However, even if the imbalance is not a good measure of existing Japanese import barriers, it probably does give an accurate indication of U.S. leverage in obtaining concessions. How else ought one to interpret negotiations in which one party’s “gain” is typically the other's failure to impose threatened new barriers?

Rapp's description of the process by which U.S. government officials promote greater access for U.S. firms in the Japanese market suggests that the allocation of market-opening efforts across products depends mainly on who finds it worthwhile to come in and complain. Yet a barrier that is quite unimportant from the point of view of U.S. national welfare may nonetheless loom
very large to a particular firm or industry association. Did it make sense to
tackle the broad and important issue of standards certification in the context
of the aluminum baseball bat case rather than another product of greater
economic significance? Does some overall logic guide the government's
allocation of effort across products and industries? It would be interesting to
know whether day-to-day U.S. efforts to open Japanese markets depend on
something more than the squeaky-wheel-gets-the-oil principle.

Another lesson that Rapp's chapter brings home is that trade policy and
domestic policy cannot be separated neatly; it is unrealistic to think that trade
negotiations can stop at national borders. Rapp appropriately emphasizes
the need to pursue such legitimate domestic goals as regulatory standards in a
way that does not discriminate against foreign suppliers, an issue addressed
in the Tokyo Round codes. Yet the Japanese hardly have a monopoly on the
use of regulatory standards to restrict trade. Indeed, Rapp implicitly
recognizes this in stating that the important question to be addressed is not
whether the United States or Japan is more open in terms of tariffs or trade
barriers. Rather, he states, "the issue is whether Japan could appreciably
reduce trade frictions, improve the current trade imbalance, and assist inter-
national trade by a dramatic change in negotiating posture and a real reduc-
tion in present trade barriers."

Rapp's answer to this question is a strong yes. While I enthusiastically en-
dorse Rapp's basic policy prescription (and believe the same medicine would
be equally salubrious for the United States), I do not agree that an improved
current account for the United States is one of the likely outcomes. If the pre-
sent trade deficit of the United States is indeed a problem, and I concur with
those who say it is, a different approach is required to solve it.

Why Do We Single Out the Japanese?

To put Rapp's discussion of Japanese barriers into perspective, it is useful to
begin by asking why it is that the United States focuses so much attention on
Japanese trade barriers. There are really two reasons, and both come out
clearly in the chapters in this book. The first is Japan's record of sustained
high growth, a record assumed to be connected intimately to the nation's
trade policy. The second reason, a related one, is the huge bilateral trade im-
balance, especially at a time when U.S. merchandise trade as a whole is
posting new record deficits.

Free traders are uneasy about the Japanese case, while U.S. protectionists
celebrate a presumed link between Japanese economic success and protection
of domestic markets. If there is indeed a causal relationship, the Japanese ex-
perience stands as a major exception to the doctrine that import protection is
generally harmful even to the country that practices it. This possibility raises
concern in part because it provides the Japanese with a motive beyond mere appeasement of sectoral interests for maintaining closed markets, especially in the newer high-technology industries where U.S. producers currently have the competitive edge. Moreover, there is the likelihood that developing nations trying to emulate Japan's success will close their own domestic markets to manufactured imports, thus cutting off major U.S. export markets.

That protected domestic markets played a key role in Japanese industrial successes is widely accepted, although with no persuasive demonstration of a causal link. Most purported evidence for the benefits of Japan's infant-industry protection begins and ends with the fact that a once-protected industry eventually became internationally competitive. Admittedly this already sets the Japanese experience apart from that of most other nations attempting to follow the same path. It remains nonetheless to be shown, first, that the industries in question would not have grown up in the absence of the protection, and, second, that the economic burden of the protection did not outweigh the eventual benefits. But whatever the merits of the as yet untested assertion, the widespread belief in its validity surely helps to shape U.S. attitudes toward Japan as well as Japanese attitudes toward the United States.

The Bilateral Trade Imbalance

For those convinced of the link between closed markets and growth, the large imbalance in U.S.–Japan trade is the "smoking gun"—supposedly incontrovertible evidence that Japan has been growing at the expense of the United States. In his chapter, Rapp returns to the trade imbalance again and again, implying a significance for domestic unemployment in the United States.

What is puzzling in the stress on the bilateral trade balance is that although the United States surely has not succeeded in peeling all the layers off the onion, there seems little question that the Japanese market is becoming more open to foreign goods and services. Yet Japan's trade surplus continues to grow. The obvious explanation is that aggregate trade performance is determined mainly by other things. Likewise, the extraordinary growth of the U.S. merchandise-trade deficit has occurred at the same time as a strong domestic recovery and large drop in U.S. unemployment. Thus, caution is required in linking aggregate trade performance and unemployment rates.

In a multilateral trading system, there is no reason to expect any two nations, among many, to have balanced trade. As a nation that imports most of its raw materials and food, Japan must run a global surplus in manufactured products to maintain overall balance in merchandise trade. The true significance of the large bilateral deficit in U.S. trade with Japan is that it gives U.S. officials considerable leverage in negotiating with their Japanese
counterparts, simply because the Japanese have much to lose from further restrictions on their access to the world's largest single market. But successful exercise of that leverage will mainly alter the relative positions of different U.S. industries (or bilateral balances with different trading partners) rather than improve overall U.S. trade performance.

Both visible and invisible barriers do matter at the industry level; they are important in determining the gains from trade and the distribution of employment across industries. However, their effect on the trade balance and on aggregate employment is likely to be minimal, with direct gains offset by corresponding losses in other sectors or in other bilateral relationships.  

How U.S. Capital Flows Shape Trade Performance

William Rapp tells us that the Japanese are the biggest beneficiaries of the open economic system in the world today, and his evidence is in the Japanese trade surplus. I would argue that the United States has equal claim to that distinction, and the U.S. trade deficit is the proof. To understand the recent situation of the United States and Japan, it is necessary to examine the U.S. capital account as well as the current account.

The United States has been running a huge government fiscal deficit. That has meant a huge reduction in total national saving (private saving plus public saving). If the United States were a closed economy with no international transactions, that reduction in saving would have to be matched by a corresponding fall in domestic capital formation—what is usually called "crowding out." But instead the United States has enjoyed an investment boom. How can that be?

The answer is simple. The United States in effect exports the crowding-out by borrowing from abroad at a phenomenal rate. Since, in a flexible-exchange-rate system, the current account (merchandise trade plus services and unilateral transfers) and the capital account must sum to zero, the U.S. current-account deficit is the necessary accompaniment of the capital-account surplus. This is achieved by appreciation of the dollar to the point that enough U.S. exports are crowded out, and enough U.S. imports crowded in, to make the current-account deficit match the capital-account surplus.  

It has become commonplace to argue that the U.S. trade deficit is so big because the value of the dollar is so high. In fact, the truth is just the opposite: the value of the dollar must be high enough to produce a current-account deficit equal to the nation's capital-account surplus. Although the current account also includes services and unilateral transfers, most of the short-term response to the value of the dollar comes in merchandise trade.

A similar argument applies to Japanese current-account performance. The present expansion of Japanese investments abroad, reflected in that nation's
The Federal Deficit and U.S. Capital Inflows

Some analysts suggest that the role of federal borrowing is minor, attributing the dramatic growth in U.S. net capital inflows instead to such factors as the Third World debt crisis, stagnation in Europe, and the like. As evidence they note the relatively small part of federal debt held by foreigners. This line of reasoning fails to recognize that at least some U.S. issues are more attractive to Americans than to foreign holders; in such instances, domestic lenders buy U.S. government securities when they might otherwise have acquired foreign assets. The large U.S. capital-account surplus reflects both increased foreign lending to the United States and reduced U.S. lending to foreigners.

There is, however, some validity to the argument that investor preferences are partly responsible for the size of the capital-account surplus, and, thus, for the extraordinarily strong dollar. The recent investor preference for dollar assets reduces the cost to the United States of borrowing to finance the deficit, and it means that more of the resulting crowding-out of private capital formation is shifted abroad. If the tastes of investors at home and abroad were to shift away from dollar assets, the result would be higher interest rates at home, a lower value of the dollar, more domestic employment in sectors competing directly with foreign goods, and less domestic employment in interest-sensitive activities such as construction.

On the other hand, the United States has taken several actions with the effect, presumably intentional, of increasing the attractiveness of U.S. assets to foreign holders. These actions include a variety of special bond issues and, more important, the elimination in 1984 of the 30-percent tax previously paid by foreigners on interest from securities issued in the United States. Such measures may reduce the cost of financing the federal deficit, but they also increase the upward pressure on the value of the dollar.

Liberalization of Japanese Financial Markets

The link between trade and the capital account is especially significant in the U.S.–Japanese context because some recent negotiations with the Japanese aim to alter the dollar–yen exchange rate, or at least that has been the public explanation of U.S. efforts to get the Japanese to open up their financial markets. Specifically, it has been claimed that increased use of the yen as a form of international money will help to bring down the value of the dollar in terms of other currencies, particularly the yen. This argument is a rather curious
one, since the dollar served as the main form of international money in years when it was as undervalued relative to purchasing-power-parity as it is over-valued today. Moreover, the continued international use of the British pound has not prevented its value from reaching new lows relative to the dollar.

Over the longer run, financial liberalization could affect the dollar–yen exchange rate through its impact on the net private rate of saving in Japan. Just as U.S. capital inflows reflect a private rate of saving that is low relative to federal dissaving (the deficit), Japanese capital outflows are financed by private saving that is high relative to government dissaving. Japan’s financial system has provided strong incentives for household saving and relatively poor access to consumer credit. There is some presumption that liberalization could result in a lower savings rate. However, the decisions of firms as well as households will be influenced by the new policies. The overall effect on capital outflows and on the value of the yen will depend on the net effect on Japanese saving relative to domestic investment demand. The long-term effects are thus uncertain even in direction.

There are also important short-term consequences of the “dollar–yen” agreements, which are really agreements to liberalize trade in financial services, or, more specifically, to ease access of U.S. firms to the Japanese market for financial services. This is certainly a worthwhile achievement—liberalization of trade in services is as important as liberalization of trade in goods, and much less has been accomplished in this area. Nonetheless, the immediate impact will surely be to reduce rather than to increase the international value of the yen by further facilitating capital outflows from Japan to the United States.

A Message for U.S. Trade Negotiators

The United States needs to do the right thing for the right reason. Reducing trade barriers is important, but the reason is not that it will eliminate or even nibble away at the bilateral trade imbalance. Opening Japanese financial markets is important, but the reason is not that it will raise the international value of the yen. The right reason is that these actions increase mutual benefits from trade by allowing imports and exports of goods and services to better reflect underlying relative costs.

U.S. public officials, not uncooperative trading partners, are the main force behind the nation’s huge trade deficit. To reduce the trade deficit without creating serious problems elsewhere in the economy, the United States must cut the federal deficit. If U.S. officials push trade liberalization as a way to get the trade deficit down, or push financial liberalization as a way to get the dollar down, disappointment is inevitable. This approach to trade negotiations lays the groundwork for a new protectionist initiative based on the fallacious conclusion that the Japanese just will not play fair.
Notes

1. In a recent example of similar action in the United States, four major cement producers, acting jointly under protection of the Noerr–Pennington doctrine, brought numerous environmental lawsuits intended to halt imports of Japanese, Australian, and Indonesian cement. For details on this public-spirited effort to preserve the habitat of the endangered brown pelican, see The Wall Street Journal, December 28, 1984.

2. For the record, however, it is worth noting that by virtually any yardstick except merchandise-trade balance, Japan’s market is less protected overall than those of most U.S. trading partners. Careful documentation is provided by Gary R. Saxonhouse, “The Micro- and Macroeconomics of Foreign Sales to Japan” in Trade Policy in the 1980s, ed. William R. Cline (Washington, D.C.: Institute for International Economics, 1983). Also see the discussion by Seiichiro Ohnaka in this book.

3. For example, Thomas Pugel’s chapter in this book appears to endorse the position that “Japanese industrial policy historically can be viewed as a largely successful application of the infant-industry approach,” although he clearly means by this only that most of the infants did eventually mature—by itself a noteworthy feat in light of experience elsewhere. Pugel goes on to state explicitly that “quantifying the incremental impact of government policy on the development of these industries is a formidable task beyond the scope of this chapter.”

4. The role of direct government action in promoting the growth of new Japanese industries appears to be decreasing. See Pugel, op. cit. and Gary R. Saxonhouse, “Tampering with Comparative Advantage in Japan?” (text of a November 1983 prepared statement submitted to the U.S. International Trade Commission for hearings on foreign industrial targeting practices available as Seminar Discussion Paper no. 124, Research Seminar in International Economics, Department of Economics, the University of Michigan). Rapp indicates that recent industrial policy has included efforts to protect depressed industries whose growth was earlier fostered. In most cases, this protection is accompanied by reduction in domestic productive capacity.

5. Remark that this, William Brock, the U.S. trade representative, says he has a nightmare—that the Japanese do everything he asks, but nothing changes.


7. Until Bill Brock convinces his colleagues in Washington to get the fiscal deficit down, his nightmare is likely to be reality—U.S. progress in negotiating with Japan on trade barriers will be offset by just enough further appreciation of the dollar to get the capital account and the current account matched up again. See H. Peter Gray, “International Crowding Out: Concept and Policy Implications,” a paper presented at the annual meeting of the Eastern Economic Association, New York, March 17, 1984.

8. See chapter 5 in this book.