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CONGRESS PROCEEDINGS
NATIONAL ECONOMIC POLICIES AND THEIR EFFECT ON WORLD TRADE

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I have been asked to examine the impact of national economic policies on world trade. Approached from a global perspective, even superficially, this is, of course, a massive and complex subject. It could keep us all here for weeks as it has others, at various UNCTAD conferences or at the recent Tokyo round negotiation in Geneva. Therefore, I shall limit my presentation to contrasting two economies with very different economic policies that have had dramatically different impacts on world trade. You might say, though, how trivial, only two countries. Yet these two countries are the two largest economies in the world, accounting for over $3 trillion in GNP and over $400 billion in total world trade. Thus, their impact on the world economy, on world trade patterns, on foreign exchange markets, on currency flows, in fact on our economic future, is profound. I am referring to Japan and the United States.

As I shall also indicate, these two countries’ contrasting postwar economic development has been a direct result of different economic policies. So national economic policies in an interrelated world do have a direct impact on world trade and on other countries who trade or compete with a particular country. But more importantly, the current consequences of contrasting U.S. and Japanese postwar development and of their different competitive positions are being exacerbated by a continuation and worsening of poor U.S. economic policy in the face of superior Japanese competition. In the near term, this situation has and will result in rising tensions between the two countries and in an unstable world trade and currency environment until some basic policy changes are made. Such a scenario is not a happy prospect for any business or country. Nevertheless, examining the present situation of U.S. — Japanese competition in world trade, the picture really is not bright. Yet, it is not without some hope if we can clearly understand where we are, how we got here, and what might be done to balance the situation on a fundamental long-term basis.

The Problem — Japan as a Superior Competitor

The U.S. is no longer the world’s leading industrial power. It has not met the competitive challenge of a better organized, more productive, and faster-growing economy. Japan. 1978 was a Watershed Year. At 190 Yen = 1 dollar, per capita GNP of $9500 essentially equalled the U.S. ($9600), while per capita GNP from manufacturing was 50% higher. Japan had an industrial trade surplus of $77 billion compared to a U.S. deficit of $4.8 billion. Her manufactured exports totalled $96 billion, essentially the same as the U.S.‘s $100 billion. Although America has twice the population and GNP, manufactured shipments were equivalent too. In addition, her absolute gross level of investment was comparable at $340 billion as was plant and equipment investment ($144 billion versus $148 billion). Investment rates about twice America’s and higher real growth rates mean that Japan will clearly pass the U.S. as the world’s leading industrial power in the early 1980’s despite any exchange rate fluctuations.

De facto U.S. postwar industrial and economic policies, would in any case have led foreigners to exploit U.S. competitive weaknesses. However, Japanese firms assisted by favorable government policies have been particularly successful. Indeed, as just noted, Japan has achieved a sobering and unparalleled concentration of competitive power. This will only be beneficial if it focuses proper attention on U.S. competitive problems, the need for policy change, and a more successful model for competitive development. However, this concentrated challenge is also worrisome given the high probability of increasing international economic tensions and continuing U.S. weakness if sound new policies are not very rapidly developed.
Such tensions could have serious consequences for America's importants Japanese military and political relations as well. More generally, they would signal continued pressure on the dollar and on U.S. world leadership. Since the policies needed to make the U.S. more competitive would reduce many domestic economic ills (e.g. stagflation, unemployment, and competing social objectives), international weakness implies continued domestic economic turmoil. Conversely, a more productive, more competitive, more efficient economy would alleviate inflationary pressures, create more jobs and provide a larger faster growing economic pie to support national goals, while reducing current and potential problems with Japan and others.

The objective here is not to present a full range of national goals and priorities but only one. The U.S. must be able to compete with Japan if it is to retain the economic base to remain a dominant world power. This must be an important national policy objective. The benefits more than justify it. Japan needs a strong and predictable ally and the U.S. needs better Japanese relations, an improved payments balance, a stronger dollar, and reduced world economic tensions. To achieve this goal the U.S. need not remake itself in Japan's image. Profound historical, political, and cultural differences prevent this. The economic fundamentals required are actually straightforward and within its grasp. The political will and educational follow-through, however, will be difficult. The only adequate response to the competitive challenge is a fundamental political economic reorientation: a substantial resource allocation shift towards investment, trade, and technology and a change in regulatory policies and in the sharing of regulatory costs. Current U.S. policies are woefully inadequate to meet its competitive problem. Its bilateral trade deficit (excluding freight and insurance) which was $5.5 billion in 1976 rose to $11.8 billion in 1978. At the same time Japan's overall trade surplus was $9.9 billion, and $24.7 billion. Conversely, the U.S. overall trade deficit was $7.4 billion and $30.9 billion.

Examining just manufactures, the situation looks even bleaker, since almost all of Japan's exports are manufactures, though not for the U.S. The U.S. overall trade surplus in industrial goods of $20.5 billion in 1975 deteriorated to a $4.8 billion deficit in 1978 while Japan's overall surplus improved from $44.3 billion to $77.0 billion. The bilateral situation was similar, as Japan's manufactured goods surplus rose from $7.7 billion to $19.2 billion.

**U.S. Competitive Difficulties**

The reasons for the bilateral and global imbalances are the same. Major U.S. industries are declining competitively. World trade in the manufactured goods primarily produced by major industrial countries is dominated by a few large multinational companies who compete for the same markets. In the U.S., some 250 firms account for over 75% of U.S. exports. In Japan some 200 firms (not including trading companies) account for roughly 64% of exports. These companies compete for sales in the U.S., in Japan and in third markets. A loss of export sales by GE or GM to Hitachi or Toyota in Saudi Arabia has as much negative impact on the U.S. payments balance as a loss in the U.S. or Japan. The U.S. has lost such sales. To decrease the trade deficit, major U.S. exporters must be more competitive domestically and internationally.

Japan sells little the U.S. does or could make. Yet is has a massive bilateral deficit in manufactured goods, with no discrimination against U.S. manufactures in the U.S. market. It suffers from excessive imports and declining domestic competitiveness in addition to any
difficulties exporting to Japan. Indeed, a Boston Consulting group study for the Treasury indicates the U.S. has lost market share in Japan to the EEC and more developed Asia as well.

The lessons are clear-cut. Markets for traded commodities are global and decreased competitiveness is reflected in all markets, domestic and export. The impact on the U.S. deficit is thus doubled. It loses export earnings and increases imports.

The competitive problem is continuous since increased sales improve a competitor’s productivity. The largest Japanese firms with the largest domestic share have the largest export share too. The marginal U.S. firm thus competes with the most successful, most efficient Japanese producer. The small U.S. firm’s lost market share in turn helps develop the large Japanese firm’s global competitive position against the leading U.S. producers. Anti-trust policy that prevents declining U.S. industries from rationalizing production exacerbates this. The biggest Japanese inroads into U.S. domestic and export markets are in industries where economies of scale in production and/or marketing are important, and where there are small inefficient producers.

The required U.S. Policy Response

Appropriate competitive policies must both offset actions that have raised user costs and have lowered normal productivity increases and must also improve on historical performance. The U.S. must shift real resource allocation to achieve more rational burden sharing and to improve savings, investment, technology, and production costs. Though these resources will come from business, consumers, and government, the shift is really dependent on government policies and initiatives. The U.S. needs a different conceptual framework for formulating such economic policy which recognizes that:

1. Successful economic policy is a long-term proposition;
2. Economies, industries, markets differ and constantly change and develop, so policies must be both dynamic and industry specific;
3. Markets are multinational, so policies must view competition globally with competitive success rewarded domestically and overseas;
4. Countries have different regulations, so regulatory policies, including anti-trust, must be flexible and consider the cost competitive impact of each regulation;
5. The keys to long-run economic success are a high savings rate and high investment levels leading to solid growth, productivity improvement, low inflation rates, international cost competitiveness, and a strong currency, so policies must promote savings and investment;
6. Government’s role should be limited and should emphasize direction rather than control, so government needs to cooperate with business and labor to achieve economic goals.

Since current U.S. policies may be so adverse that only a few U.S. firms can develop viable competitive strategies, U.S. firms may invest overseas to escape its costs, lowering U.S. investment and productivity. One thus needs a new policy perspective to develop an integrated set of initiatives under which U.S. industry can compete with Japan. Yet, this must be done within a
U.S. institutional, business, and cultural context. In this One is asking not for more government but for more intelligent government and a better quality of policy. Indeed, in many cases One is just asking for more common sense. The following outlines such an approach:

1. *Encouraging Savings and Investment.*— Current tax, fiscal, and monetary policies discourage savings and investment by raising user capital costs and by offering savers a negative real after-tax rate of return. Government investment is small, 2-3% of GNP; expenditures are for goods and services or transfer payments. Rising expenditures press on existing capacity, and deficits put pressure on credit markets for available funds. Rising interest rates raise costs and prices further. Some new investment is discouraged, lessening capacity available for the next upswing, when inflation then mounts sooner at higher unemployment levels.

**Recommendations**

Fiscally the government should contain expenditures, targeting budgetary surpluses or at least a balanced budget. Savings could be returned to business via specific incentives.

Tax incentives to increase savings and investment could include elimination of double taxation on dividends, deductibility of preferred share dividends, more rapid plant and equipment depreciation, restoring depletion allowances, tax-free interest on the first $10,000 of savings deposits, lower capital gains taxes, special write-offs on a replacement basis for scrap and build, lower corporate tax rate, lower personal tax rate on interest and dividends, and a value-added tax replacing some social security or corporate taxes. Eligibility for some incentives could be tied to the wage-price guidelines. Competitive pressures would then assure compliance.

As tax, fiscal and monetary measures should be coordinated, the Fed should continue its present policies of not restricting credit availability while keeping money supply growth at reasonable levels relative to real growth. Over time the gap between real and money growth should be narrowed. Interest rate ceilings should allow savers a positive after-tax, after-inflation rate of return.

2. *Encouraging Global Competition.*— To improve world market share the U.S. needs to overcome the risks and costs inherent in developing and expanding export markets.

**Recommendation**

It should introduce specific tax incentives for exports such as a special reserve for overseas marketing costs, accelerated depreciation for export-oriented plant expansion, expensing of overseas marketing investments, and a rebatable value added tax.

Potentially the U.S. has a comparative advantage in energy-intensive industries. Competitively, Japan and Germany pay more per but than America does. The error has been mandating increased costs for oil energy substitutes. (e.g. cost of coal and nuclear generation plants rose 400% per kwh between 1969 and 1977, of which 300% was directly due to regulation).
Recommendation

The U.S. needs a rationale energy policy and should reverse or offset the producer costs of regulatory constraints that have made alternative energy sources like coal, and nuclear more expensive than oil and gas.

3. Recognizing Differences Among Industries Over Time.— Industries' economics, development stages, and competitive requirements vary over time. Policies should change accordingly. For example, present regulations (safety and pollution) primarily affect mature capital-intensive businesses producing price sensitive commodities. These industries are most vulnerable to foreign competition, and are most adversely affected by current tax laws (long depreciation lives and high inflation) and by high interest rates. 75% of all industry pollution expenditures are accounted for by six industry groups. Similarly, reductions in historical productivity are concentrated in mining, utilities, and construction. Long-term ex ante union wage settlements for these industries compound the inflation problem when anticipated productivity rates aren't achieved. Yet the pollutor doesn't pay, the consumer does in an inflation tax, and international competitiveness is simultaneously reduced. One must control the cost impact of government regulations on specific industries.

Recommendations

The government should allow expensing or very rapid write-of pollution-related expenditures. Tax credits might even be considered to compensate for Japan's competitive edge. Currently 3-4% of U.S. GNP goes to all regulations, but it is only investing 17-18% compared to Japan's 30%. Competitively, America's economy and industry can't handle the relatively higher diversion of productive resources. Such tax policies would also force lawmakers to make the appropriate budget/benefit trade-offs for various regulations.

More government, business, labor cooperation and less recourse to confrontation, litigation, and multiple licensing would also be beneficial. The U.S. might even get more benefit for its regulatory dollars.

The government should pursue selective favoritism according to strict criteria: promote key emerging industries or those strategic for the economy and defense. Producing firms should be as efficient and internationally viable as possible. A service economy still needs an efficient competitive industrial base. Supporting losers is expensive and counter-productive. Some favoring of particular industries is inevitable. But the U.S. should change its focal point to favor those on the cutting edge of industrial development.

Declining industries should not be propped up by tariffs or quotas and industry rationalization should not be blocked by anti-trust as long as international competition will keep prices down. A large declining industry eats up productive resources at low rates of return. These are resources America can't afford to waste. It must overcome its fear of corporate bigness and take a global competitive view. A large and growing world economy requires this, especially where economies of scale are competitively important.
The above or similar policy recommendations will reduce direct user costs and the user cost of capital while increasing investment, saving, and technology. In the long-run they represent the only fundamental solution to stagflation. They have been recommended in part at various times by commentators, economists, congressmen, government officials and businessmen. Individually, they are not conceptually unique. However, they need to be systematically implemented as an inter-related and mutually supportive set of actions that make economic sense as a solution to U.S. domestic economic ills, the balance of payments problem and the competitive difficulties with Japan.

Current Policies are Inadequate

The current policies of floating exchange rates, trade-related pressure tactics, greater export consciousness, the energy program, or the dollar support package do not address the fundamentals. They will not change investment levels, productivity, or resource allocation. At best they offer time to improve investment, growth, productivity and export competitiveness. At worst, they aggravate present difficulties, leaving few options for future maneuvers. Further, because the U.S. doesn’t live in a policy vacuum there are time pressures. It cannot gradually introduce or postpone such a program. Japan has had a similar one in place for some time with adverse consequences for the U.S. While America has printed money to pay for imports, the Japanese have strived for export competitiveness. Quite logically, their policies are almost the opposite of America’s. If the U.S. is to compete effectively it must squarely face this competitive differential. Alternatively, if it can compete with Japan, it can deal with anyone it has to.

Specifically, Japan’s development as a superior competitor has evolved from a different view of the requirements for successful economic performance. I am not holding Japan up as a ready model for U.S. development and economic management. But understanding Japan’s view is essential to developing the competitive strategies and resource allocations appropriate to today’s economic realities. In turn, as noted above, such a viewpoint translates directly into national economic policies with profound competitive implications.

In particular, Japan’s perspective has led to an interrelated set of measures that have created a policy environment conducive to successful business strategy development.

1. *Postwar policy has emphasized savings and investment, while avoiding excess transfer payments.*
   Both macro and micro data indicate that higher levels of capital formation and technological improvement are the keys to Japan’s higher growth rates, improved productivity, greater price competitiveness, expanding markets, and in turn more investment. Personal savings have been encouraged by tax laws (e.g. tax-free interest on savings accounts and no capital gains tax on securities transactions) and the low level of transfer payments like social security.

2. *Government policy has systematically allocated resources towards business resulting in lower user capital costs.*
   Rapid depreciation, special reserves, fiscal surpluses, scrap and build incentives, and aggressive monetary policy have kept business savings, credit availability and debt
capacity high. Though some 85% of pollution expenditures are paid for or financed by government agencies, competitively the greatest offset to mandated costs are the high savings rate and the ready availability of low cost capital.

3. *Emphasis has been on government, business, labor cooperation* to solve problems in advance, to facilitate industrial change and technological absorption, and to promote international competitiveness. Wage settlements, for example, are negotiated yearly on an *ex post* productivity plus inflation basis.

4. *Government policy recognizes industry differences over time* in economics, development stages, and long-term national benefit. Rationalization of uncompetitive industries is a conscious objective (e.g. textiles and aluminum). This leaves more resources for new sophisticated higher growth industries and helps remaining firms to stay competitive. Fiscal, regulatory, and tax policies favor winners. Selective protectionism to develop new industries is clear. Japan's long-term survival requires constant upgrading of employment opportunities. Anti-trust policies are flexible as policy recognizes the importance of bigness for cost competitiveness domestically and internationally.

5. *Export policy is an integral part of total economic strategy to pay for imports and to extend the competitive life of Japanese business.* Such policies have led to greater cost competitiveness and less inflation. Higher savings rates reduce the income multiplier effects of high investment rates, government deficits, and mandated expenditures. For example, each economy spends about 2% of GNP on pollution. However, the overall price effects in Japan have been minimal. The competitive issue seems not so much the regulations and expenditures themselves as their funding. Dynamically greater competitiveness fosters improved exchange rates and lower interest costs, a beneficial cycle furthering long-term competitive growth, and improved quality of life, and even less inflation. By contrast:

1) U.S. gross fixed capital formation's share of GNP is the lowest of any major industrial country (17%), little more than 1/2 Japan's.
2) Personal savings rate is also the lowest – about 1/4 Japan's (6% of disposable income vs 24%).
3) U.S. R and D's share of GNP is declining while Japan's is rising.
4) Despite Japan's recent "recession" due to an excess of desired savings relative to investment, Japan's real growth rate has equalled or exceeded U.S. rates since 1973.
5) Yet since 1975 U.S. wholesale prices are up 21% versus Japan's 3%, and export prices are up 27% versus Japan's decline of 12%.
6) Their trade surplus since 1975 is up $19.7 billion; ours is down $40.9.

The competitive consequences of a superior policy framework are real, direct, and obvious. In addition, present U.S. policies are woefully inadequate to redress this performance differential.

1) Floating exchange rates have little competitive impact if fundamentals are unchanged. Large Japanese firms can absorb much of the change, especially where imported raw materials or overseas marketing costs are a large portion of the delivered price. Revaluation primarily hit the marginal producer in marginal industries, rationalizing them and improving the leading
producers' competitiveness. Revaluation stimulates cost saving and modernization while reducing inflation and interest rates. Highly leveraged Japanese firms benefit directly from low cost credit. The reverse situation is true for the U.S. where rising exchange and interest rates raise both supply costs and domestic demand. Floating rates only offer a short-term adjustment, or a one-time opportunity to improve market position. New rates must be followed by appropriate changes in the fundamentals to provide any long-term assistance. At worst, floating rates act as a policy opiate which continuously but unsuccessfully tries to substitute for basic policy change.

2) U.S. pressures on Japan to grow faster or to liberalize imports have a marginal impact on U.S. competitiveness. Japan's and Germany's postwar economic history shows that exports have actually expanded faster than imports in periods of high domestic growth, reflecting greater cost competitiveness from higher investment rates and productivity improvement. In the U.S. where economic growth has generally been demand rather than supply stimulated (e.g. government expenditures, devaluations and tax cuts, rather than increased investment or productivity), growth has meant more imports as the U.S. ran into supply constraints. It shouldn't, however, project its economic policy views onto others. Currently Japan is pursuing its expansion plans via aggressive monetary policy and more public works (an investment approach similar to past policy). But the U.S. has increased its marginal propensity to import since 1965 from about 3% to 8% as a result of the Vietnam War and the Great Society programs that led into increased regulatory costs, environmental expenditures, and energy shortages. This has exacerbated and interacted with the compounding inflation rate and a declining dollar.

3) A more open Japanese economy or more export-minded U.S. companies will not rectify the situation either. America must first be cost competitive. Arguably opening Japan could help emerging or existing competitors in third countries while further rationalizing Japanese producers, making all more effective competitors vis à vis the U.S. Nor is it clear that the problem is U.S. firms' low export consciousness. The leading 250 American Exporters account for over 75% of U.S. exports. This averages $476 million per firm, and compares favorably with the leading 200 Japanese firms' average of $214 million. Additionally, American firms have difficulties competing in the U.S. much less Japan. Greater export incentives, export consciousness, and liberalization are important and would be beneficial if achieved. But they are not the crux of the competitive problem. Loss of global market share is more understandable given a rise in Japanese wholesale prices since 1975 of only 3% while U.S. prices are up 21% or given that Japanese export prices in Yen terms have declined 12% versus U.S. dollar export prices up 27%.

4) Attribution of the payments problem, U.S. inflation and U.S. loss of competitiveness to oil imports and OPEC is also somewhat misplaced. U.S. energy prices and oil imports relative to GNP and population remain well below Japan and Germany. These countries pay higher domestic oil and energy prices while running large payments surpluses and maintaining low inflation rates.

5) Finally, the current dollar support package does nothing to change basic resource allocations, while higher interest rates potentially discourage investment and without a major recession raise costs and prices. In sum, while current policy approaches could have some validity and benefit, as a comprehensive program to deal with the essentials of its competitive problem they are inadequate.
Summary

The solution to U.S. competitive weakness vis a vis Japan really requires a reallocation of its national resources. While Japan has put its funds into investment and technology, America has consumed not only a larger portion of its real GNP but some of its existing stock of capital. U.S. firms have fallen badly behind in the rate of productive investment and technological improvement, and are now falling behind in absolute levels as well. In addition, government in Japan has cooperated with industry, has promoted rationalization and international competitiveness, and has directly and indirectly cushioned the cost competitive impacts of mandated expenditures and regulations. The U.S. has not. If there is no change in basic U.S. policies then Japan's competitive differential must remain and compound. Lower savings and investment rates mean declining productivity, more inflation, less research, a weaker dollar, higher capital costs, increasing world economic tensions, rising internal disaffections ad infinitum. Continued government regulations for their own sake without appropriate political trade-offs, cost-benefit analyses or user cost offsets exacerbate this. Reduced to its simplest terms, the economy's rational and coordinated management is both an economic and political necessity for survival in a competitive world. Such a major change in political economic ideology requires government, business, and labor to work together on a national reeducation effort. The alternative is not attractive: increased world economic tensions, declining U.S. credibility, and increased internal squabbles over a smaller economic pie. Any analysis of competitive policy interaction has to lead to this conclusion because in the future the Japanese cannot be expected to alter their logical systemic formula for economic success. America's fate therefore remains where it always has been, in its own hands. Only if it can meet this challenge, will the world as a whole benefit and will the 1980's be other than a worsening continuation of the 1970's.