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INDUSTRIAL STRUCTURE
AND JAPANESE
TRADE FRICTION:
U.S. Policy Responses

The United States and Japan often appear to be mirror images. The United States has a large land area, many natural resources, including abundant energy supplies, a massive defense establishment, a low rate of savings, and a diverse economic structure. Conversely, Japan’s land—especially arable land—is limited; its natural resources and fuels are largely imported; its defense commitment is restrained; and despite a high rate of savings, her export competitiveness lies across a narrow band of manufactured goods. Such structural differences are at the heart of U.S.-Japanese trade frictions, whether one is talking about the issue of access of U.S. agricultural commodities, manufactured goods, and services to the Japanese market, or the competitive pressures created by Japanese manufactured exports to the United States and the rest of the world market.

Unfortunately, the frictions created by these differences are large and growing. High unemployment in the U.S. steel, auto, lumber, and other industries generates personal hardships and in turn, political pressures. Similarly, there is genuine concern over Japanese competitive “targeting” of U.S. high-technology industries, including aircraft, semi-conductors, computers, pharmaceuticals, and automated machine tools. Within this context, appropriate U.S. policy responses are both expected and required. Letting events take their course—having the market decide what will happen—is not a viable option. Such an approach ignores the impact of government actions and institutions on the market in both countries and the world as a whole. Furthermore, such policies are likely to increase bilateral tensions to serious, perhaps explosive, levels as important structural differences persist and frictions continue to escalate over time. Given the importance of Japan as an ally and trading partner to the United States and other Western countries, the American policy response must deal with the fundamentals of U.S.-Japanese competition as determined by these structural differences.

Such policies fall into two major categories: (1) specific industry- or product-related thrusts such as orderly marketing agreements (OMAs), access to the Japanese market, and government support for U.S. high-technology firms; and (2) general economic policy changes affecting monetary, fiscal, and tax policies in both the United States and Japan.


So far, American initiatives have focused largely on the first area, especially on what the Japanese government can do to limit exports or open the Japanese market to American imports. However, these policies, while clearly necessary, would be much more effective if supplemented by targeted initiatives aimed at improving the competitiveness of key U.S. industries and by changes in general economic policies. More specifically, the United States needs to protect and foster its own basic and high-technology industries while increasing its overall rate of savings to improve real economic growth and industrial competitiveness. At the same time, Japan should be encouraged to lower its savings rate, increase consumption, and reduce its use of oil for power generation. In this way the United States can begin to address the fundamentals behind its persistent trade friction with Japan, while improving the strength and competitiveness of its economy.

American and Japanese Structural Dynamics and General Economic Policies

Both the American and Japanese economies are evolving toward a post-industrial or "tertiary" economy. Production of primary and manufactured goods accounts for a declining proportion of GNP while the services sector is growing. This appears to be a natural process of economic evolution. However, due to Japan’s high savings rate, this evolution is proceeding at a more orderly manner than in the United States. The reason for this lies in differences in Japanese and U.S. postwar development. After World War II, Japan had to develop a competitive manufacturing sector to provide employment and pay for necessary energy and raw material imports. Achieving this objective along with non-inflationary growth required a high rate of investment supported by a high rate of savings. To facilitate this process, the Japanese government encouraged savings by refraining from any capital gains tax, promoting tax-free savings accounts, and even establishing a special directorate within the Ministry of Finance (MOF). At the same time, the government sought to channel these savings into investments in key industrial sectors by means of the Bank of Japan’s rediscounting policies, tax and fiscal incentives, and direct loans from the Japan Development Bank. These “target” sectors changed over time as the leading edge of the economy shifted from power, iron and steel, and shipbuilding, to autos and machine tools, and finally to high technology. That is, the beneficiaries of protectionism and supports changed as the economy moved toward producing higher value-added, more sophisticated products.

The success of these economic policies is well known.


Japan has for years had the highest economic growth rate of any major industrial nation, and the cutting edge of its industry has become increasingly more sophisticated. In addition, productivity and income have risen steadily. Yet, 1972-73 clearly marks a break in this progression. Rising energy prices, domestic and export market maturation for several major products, political pressures from the other advanced countries for a reduction in exports, and LDC requests to process more raw materials, all effectively reduced demand for Japanese production as well as demand for investment. In turn, this reduced investment demand was replaced neither by growth in the less capital-intensive service sector nor by greater consumption. Incentives to save remained intact, however, resulting in an economy generating excess savings relative to domestic requirements. This kind of economic environment by its nature is quite deflationary as excess capital tries to find an outlet in (1) modernization and rationalization of productive processes, (2) new product development, (3) lower capital costs (lower interest rates and higher price-earnings ratios), and (4) more exports.

These developments are of course interactive, but appear to be limited by policy exigencies. Lower capital (interest) costs put downward pressure on the yen as investors seek higher returns elsewhere. A weaker yen encourages exports, helping to use the excess savings through transfer of physical capital abroad. However, as already noted, protectionist pressures have prevented exports from rising too dramatically, while accusations of "rigging" the yen have been running between Tokyo and Washington. In response, the MOF has tried to limit interest rate declines, thereby limiting one potential stimulus to the economy. Since the MOF also has resisted large budget deficits (negative savings by government) to take up the slack in investment, the economy must deflate or grow below its potential in order to bring about the necessary equality between investment and savings. Unfortunately, slow economic growth exacerbates the budget deficit problem.

These deflationary pressures have lessened the impact on the economy of the shift towards a post-industrial society. Japan's base manufacturing companies have been able to remain competitive, in many cases gaining a global market share in terms of exports and foreign investment. Also, the non-inflationary economic environment has supported the competitive development of Japan's high-technology industries, in particular for products such as computers, semiconductors, automated machine tools, and video tape recorders. The capital to modernize basic industry has been readily available at relatively low cost. Pollution control equipment, energy-saving investments, and automated production facilities are now in place. Today Japan has about twice as many industrial robots as the United States. Even pollution control devices, which have put a strain on many American industries, have actually benefited Japan in terms of growth, as firms made investments they otherwise would not have made, and have become leaders in a new technology.8

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6. The issue of excess savings was first raised in a major way by Professor Gary Saxonhouse, University of Michigan, at a conference held by Columbia University's East Asian Institute, May 1980.

7. In a recent Fortune article it is reported that presently only 18 percent of Japanese machine tools are over 20 years old and 61 percent are less than 10 years old, compared to 34 percent and 31 percent respectively in the United States. See also Gene Bylinsky, "The Race to the Automatic Factory," Fortune (21 February 1983): 52-64.

8. Given Japan's higher savings rate, government-mandated investments of all kinds, which account for about 1.5 percent of GNP in both countries, take a higher percentage of the savings available for new productive investment in the United States than in Japan. This puts a greater burden on what is available for U.S. growth relative to Japan.
This emphasis on modernization and rationalization in turn created substantial domestic demand for automated devices, thereby promoting Japanese leadership in this area and building the base for an export thrust into the United States and other markets. A weak yen and the availability of finance further promoted this competitive development. Similarly, the trend toward greater automation and capital intensity in the production of high-technology items like semiconductors has played to Japan’s advantage. Not only has the lower cost of capital translated into a direct cost advantage, but its impact via the exchange rate has lowered the effective cost of all Japanese inputs. Exchange rate effects not only frustrate American desires to remain competitive in existing and new product areas, but can in fact create a policy dilemma with regard to opening Japanese markets to products where the United States retains an overwhelming advantage due to availability of raw materials, energy, and economies of scale. Such industries include aluminum, pulp and paper, and petrochemicals. Any increase in Japanese imports of these products can only further weaken the yen, while also reducing Japanese investment demand in these industries. The weaker yen then makes Japanese exports in other areas such as steel, autos, and high technology even more competitive.

The flow of these competitively priced goods towards the United States is inevitable. Unlike Japan, the United States is not generating enough savings, as indicated by its persistent inflation, growing trade deficit, and high interest rates. The first two developments should generate savings by reducing consumption or importing capital. The last shows the rising cost of capital as demand exceeds supply. In contrast to Japan’s excess of savings, which has kept inflation and capital costs relatively low, the U.S. capital shortage has accelerated the decline in capital-intensive basic industries and promoted the shift toward a post-industrial economy. As recent articles have noted, American industry is far behind in automating its factories and modernizing its machinery because of high interest costs and uncertain demand.

Additionally, the greater capital intensity of new plant and machinery, pollution control equipment, and energy-saving devices has affected basic industries, such as steel, automobiles, non-ferrous metals, and chemicals more severely than the service and high-technology sectors. For the latter, the cost of major input, skilled labor, is fully tax-deductible in the year paid, productivity increases have been rapid, and major retrofitting for pollution and energy control have been much less of a factor. All this has drawn resources, especially scarce capital resources, away from basic manufacturing at a more rapid rate than would have occurred if more savings had been available. Improved Japanese competitiveness compounded these industries’ natural decline as Japanese firms captured global market share, making new investment for their U.S. competitors more difficult both to justify and to finance. The economy’s inflationary adjustment to a low rate of savings, which should have caused a decline in real consumption, merely added to industries’ problems when they found it difficult to pass on cost increases by raising prices. This process accelerated the U.S. economy’s shift toward a post-industrial society. The adjustment for the U.S. basic manufacturing sector was very difficult, because it was trapped by rising cost inflation and increased capital requirements on the one side and increased price competition from abroad on the other. The impact of “general” monetary and fiscal policy was quite specific.
While services and high technology continued to grow, steel, housing, and the automobile industry declined. However, while this shift in comparative advantage and the relative decline of the basic manufacturing sectors are clearly explicable, their declining viability is neither inevitable nor desirable. Even in Japan, which has promoted the idea of giving up its declining industries more than any country, the policy is only one of decreasing an industry’s relative contribution to GNP. In some cases, such as coal, paper and pulp, aluminum, caustic soda, and petrochemicals, the industry will be protected as older capacity is abandoned. In other cases, such as textiles and shipbuilding, the government will work out arrangements, including government subsidies, to phase out production, retrain workers, and upgrade productivity while still permitting imports. The net objective is almost always the same: to retain some modern competitive capacity that is viable, particularly in the high value-added, more technically advanced end of the market. For example, Japanese textile and apparel manufacturers have made major efforts in high fashion and have steadily improved productivity, while cheap textile imports from Korea, Taiwan, Hong Kong, and Southeast Asia have grown enormously, sometimes as a result of Japanese investments in those countries. Thus, while textile production has remained steady and employment has gradually declined, the remaining facilities and companies are viable.

American basic manufacturing, although declining, remains quite considerable in absolute terms, directly and indirectly accounting for about 30 percent of GNP. It is critical to our overall defense needs and is a large employer of minority workers. Thus, we are not in a position militarily, politically, or economically to rely totally on imports of these goods while exporting food, raw materials, services, and high technology. In addition, the success of our service and high-technology sectors is partially dependent on demand from these basic industries. A more practical strategy would be to keep a modern competitive industry, as in Japan, whose contribution to GNP and employment would gradually decrease. This would require an increase in the U.S. gross savings rate and a targeted transfer of the expanded capital resources to support modernization of industry. It may also require some limited form of protectionism while these new plants and equipment are being purchased and installed. To successfully reduce trade frictions with Japan, U.S. policies must go beyond specific commodity proposals for opening the Japanese market, and deal with fundamental U.S. tax, fiscal, and monetary policies that adversely affect the industries most hurt by Japanese trade. Such policies should be coupled with targeted policies to reestablish the productive manufacturing base of the firms in these industries over a limited time period. In theory, the discounted economic benefits flowing from a more competitive industry and fuller employment should compensate for the higher prices paid during the time required to install more productive facilities. In reality, political considerations will probably predominate.

Relying on the projected 1983-84 recovery to solve our trade friction problems is unrealistic. Already forecasters are expecting that any recovery will maintain inflation in the range of 5 percent and will freeze long-term interest rates close to current levels of 12 percent.

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as the Federal Reserve Board tightens monetary policy to avoid any resurgence of inflation. However, at this level of interest and inflation, demand for housing, consumer durables, and capital goods is not likely to be very strong. Furthermore, Japan's basic capital and manufacturing cost advantage will persist and even widen. Indeed, it will improve precisely in those capital-intensive, interest-sensitive industries that are likely to be lagging behind the economic recovery because of both high interest rates and international competition. Under these conditions, trade friction could actually increase rather than decrease if Japan is seen as denying the benefits of the economic recovery to important U.S. industries, especially in areas of continuing high unemployment.

**Domestic U.S. Policy Requirements**

Given the above, a logical set of U.S. policy initiatives would include the following.\(^\text{10}\)

1. Tax and fiscal policies should be shifted to aggressively promote savings. These initiatives would comprise a mix of substituting some specific tax incentives to save for the tax cuts implemented in 1981 and by instituting taxes on consumption. The latter could substitute for some existing personal income or corporate taxes that penalize savings, such as double taxation of dividends. Taxes on consumption could be commodity-specific, such as an additional hike in the gasoline tax to take advantage of current oil price declines and to encourage conservation. Or they could be general, in the form of a value-added tax, or a tax on income when it is withdrawn for expenditure purposes. In all cases, tax deferral is only realized if people consume less or save. Furthermore, as these taxes are only a fraction of the total amount consumed, a small tax deferral can have a large impact on savings.

2. These specific incentives to save should focus on offering tax deferrals out of future tax revenues in response to actual increases in savings or net assets rather than merely assuming people will save more at higher after-tax incomes. The package should seek to improve real after-tax returns to savings in the form of financial assets and penalize consumption of earnings on invested capital. Proposals similar to Heinz's personal investment account bill, setting up tax-free investment accounts, represent one such possibility. Under these proposals, withdrawals are treated as earnings, capital gains, or principal re-capture, in that order, and are taxed at current, capital gains, or zero rates accordingly. One advantage of this approach, as with the consumption tax approach, is that there is no immediate reduction in tax revenues as there has been with individual retirement accounts (IRAs), for example. A transfer of assets, unlike IRAs, does not by itself create a tax deduction. It is after-tax income that forms the investment base; only income and capital gains accumulate tax-free until withdrawn. Furthermore, the program could be designed to shelter only financial assets that represent a net increase in savings so that only true monetary savings from income or the

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\(^{10}\) These policy recommendations have been made several times in various articles and speeches but remain quite valid in the current context. In addition to the articles cited in footnote one, for example, see William V. Rapp, "National Economic Policy and U.S. Export Competitiveness," Testimony to U.S. Congress (Joint Economic Committee, 29 July 1980) and "Industrial Policy and Economic Survival: The Japanese Case," Testimony to U.S. Congress (Intestate and Foreign Commerce Subcommittee, 26 June 1980).
sale of non-monetary assets would be eligible for tax-exempt investment accounts.

3. These approaches to stimulating savings should lower interest rates as savings increase. This will have a doubly beneficial effect on reducing the budget deficit as the cost of servicing the government debt falls and as lower interest rates promote greater economic activity. A reduced deficit, of course, also increases the flow of available savings, further promoting lower interest rates. Therefore, this tax incentive package for savings should not have the negative effect on the budget that the 1981 tax package did.

4. Federal expenditure growth should continue to be contained to keep savings growing. Given a 4 to 5 percent desired long-term real growth rate, a gross savings rate of around 25 percent of GNP seems necessary. An increase in desired investment and net exports will in turn substitute for the relative decline in government expenditures and consumption as a percentage of GNP, though absolute consumption will be larger given a higher economic growth rate. This will be the direct result of lower interest rates, a less overvalued dollar, and eventually, a more productive manufacturing sector.

Policies to promote savings, and in turn, more non-inflationary investment are therefore essential in order to improve U.S. competitiveness in industries heavily affected by Japanese competition. More savings and investment are absolutely necessary for solid growth, productivity improvement, low inflation rates, international cost competitiveness, and a strong currency based on trade performance rather than on high interest rates. However, some changes in the attitudes behind U.S. economic and trade policies are also necessary in order to build on this foundation. This is true both for generating commodity or industry-specific proposals and in approaching the Japanese for specific concessions. These revised international competitive policy perspectives should incorporate an understanding that:

1. Growth and economic change are beneficial. Economic policy should thus seek to cushion the adverse effects of growth on specific economic sectors and to maximize its positive developments by promoting rather than opposing economic forces. Therefore, modernizing declining industries would keep firms competitive at a lower economic cost to the nation as a whole than would merely setting up protectionist barriers, which raise prices to consumers on a continuing long-term basis.

2. A successful macro-economic policy must take account of sectoral and industry differences. It also requires a dynamic long-term perspective, because economies, industries, and markets are constantly changing over time. Therefore, a dynamic disaggregated economic analysis is an important aspect of successful policy formulation. For example, energy policy is an integral part of economic strategy. Developing alternative energy sources to oil and conserving energy require higher levels of investment and structural shifts, which must be supported by a higher rate of domestic capital formation, i.e., more savings.

3. Markets are multinational and interactive. Therefore, policies must encourage international competition by rewarding competitive success both domestically and overseas. They must also recognize that competitive successes in one area may create problems in another, as countries shift resources and as varying exports and imports affect foreign exchange rates.
4. Because various countries have different institutional and regulatory environments, one's own policies and regulations must be flexible and one should consider their impact, as well as the impact of other governments' policies, on competition, world markets, and changes in comparative or absolute advantage. Some government interference in a complex pluralistic society is inevitable. At the same time, U.S. policies should be limited, emphasizing direction rather than control, and should be based on cooperation with business and labor. Government officials should not disregard the impact of their policies on the market and economic behavior.

A policy program aimed at coping with Japanese competition and trade friction would be based on increased capital generation—perhaps a logical conclusion for a "capitalistic" economy. In turn we should target strategic industries such as steel, non-ferrous metals, automobiles, machine tools, chemicals, pharmaceuticals, energy, aircraft, computers, semiconductors and financial services, which are under competitive pressure and which represent a large proportion of U.S. manufactured output, have military importance, or are on the leading edge of technology. Other parts of the economy would benefit from their improved economic performance and would not be discriminated against in terms of growth opportunities. But we still need to recognize that some industries are tremendously important to the economy and to our economic future. Therefore their competitiveness must be maintained in some way. I would suggest that the government work with business and labor to assess these industries' economic structure, factor inputs, competitive environment, and long-term requirements. For declining or mature industries, incentives to modernize or phase out some capacity over a defined time period should be established with additional incentives given to those who rebuild at existing plant sites.

At the same time, as business must see the likelihood of recapturing its investment, it will probably need some limited protection until the new investments are in place and operating. This protection could take the form of orderly marketing agreements, government procurement preferences, and local content legislation. Though the latter has been much maligned in the press and in administration policy statements, some moderate local content legislation, with standby authority for the president to raise it if there is no progress in trade negotiations, is appropriate. This would send a signal to Japan that the United States is not a "paper tiger" and will take action if necessary to maintain or bolster its key industries. Credibility is important in our negotiations with Japan since many Japanese businessmen and policy-makers believe the U.S. administration is split between adamant free traders and supporters of protectionist legislation. In addition, they feel professional lobbyists, import interest groups, and consumers can be mobilized to put opposing pressures on Congress. Given this situation, the Japanese believe they need not give way substantially in any of the major areas under negotiation. This is a high-risk approach for both the Japanese and the American administration and could lead to passage of a "Christmas Tree" protection bill, rather than a more limited and well-targeted version in which the administration retains a large degree of flexibility in negotiations.

If even limited protectionism is pursued, however, it must have a sunset provision, and it must be coupled with policies stimulating savings and targeted invest-
ment noted above. Otherwise, U.S. industry will not be able to take full advantage of this competitive respite to modernize. Protectionism will also be likely to last longer, and its costs will not be recouped in improved competitiveness and productivity in the future. Finally, foreign investors who overcome these trade barriers with modern plant and machinery investments in the United States, financed primarily by debt issued under parent guarantees and special local benefits, will have an unfair competitive advantage vis-à-vis established U.S. firms with obsolete plants, union opposition, and deteriorating cash flows. This has already happened in the television and tire industries and may soon prevail in the auto and steel industries as well.

Moreover, pure protectionism is clearly costly to the national economy and counterproductive, particularly in mature industries. A declining industry is much larger than an infant industry, so that any protectionist measures represent large costs to be reduced as soon as possible through improved productivity and greater cost competitiveness. Secondly, raising the cost of a particular product reduces the competitiveness of the industries that use it, such as the effect of higher-cost steel on the auto industry. There must be a program to make these inputs competitive over time.

The Japanese will, of course, argue that any protectionism is bad, and that the world should avoid falling back into the protectionist whirlpool of the thirties. However, what we are discussing here is not an across-the-board hike in tariffs, but a selective and temporary policy to resuscitate important U.S. industries. Indeed, this program could be viewed as merely just compensation for Japan's past protection of its key industries. The fact that they are not protecting their auto, steel, and machine tool industries now does not detract from their past policies. U.S. firms were kept out of the Japanese market until Japanese industry had grown and captured most of the home market, had begun to export to the LDCs under various export incentive programs (replacing American and European products), and eventually, had developed the competitive strength to enter the American market.

This association between protection of infant industries and development is well-documented. Japanese economic success has been based on a combination of a high savings rate and strategic use of protectionism and fiscal policy to ensure competitive development. The policy proposed now for the United States can thus be seen as compensation for the success of Japanese protectionism, since existing laws cannot protect U.S. industries from competition with the Japanese, who do not need to resort to dumping or other "predatory" practices when they finally enter the U.S. market.

In the case of new industries such as high technology, where the United States desires to maintain or improve both its competitive advantage and market share, supports will likely be based on more procurement and tax-specific incentives such as the research and development credit or lower capital gains taxes on venture capital. These industries would also be among the greatest beneficiaries of the general economic impact of a higher savings and investment rate. Less protectionist support is probably needed in these cases and in any case is less costly than for mature industries. However, some protection may be necessary in industries such as computers, telecommunications, and semi-conductors in exchange for access to the Japanese market. This might convince the Japanese we are serious not only about negotiating, but also about supporting our key industries and competing in world markets.
Journal of International Affairs

Convincing Japan to negotiate trade issues more seriously is particularly important because to achieve our long-term objective of promoting trade, we need Japan to take specific actions along with our own initiatives. So far they have not done so.

U.S. Requests for Japanese Policy Action

The current U.S. trade initiatives with Japan focus on the following goals: (1) opening the Japanese market to U.S. goods and services; (2) restricting Japanese exports to the United States in certain commodities such as textiles, steel, televisions, and automobiles; (3) maintaining our lead in the high-technology industries. The U.S. policy program examined above would certainly help to accomplish these objectives by improving U.S. overall growth and competitiveness. However, these policy prescriptions will be insufficient to reduce trade frictions with Japan if the Japanese economy remains relatively depressed. This situation will occur as long as desired savings in Japan continue to exceed desired investment. Under depressed economic conditions, Japanese negotiators will remain extremely reluctant to open markets to U.S. exports of citrus, beef, aluminum, fertilizers, petrochemicals, pulp, and lumber if they have nowhere to transfer the workers who will be displaced. Moreover, any large increase in U.S. imports would strengthen the dollar against the yen, making U.S. high-technology exports more expensive and Japanese products less expensive, adversely affecting our high-technology strategy. There will also be an increase in the natural flow of resources to these growth industries as opportunities in other sectors are reduced due to stiffened U.S. competition. This latter development is particularly likely if the United States and the European Economic Community (EEC) continue to restrict current major Japanese exports like automobiles, televisions, and steel, and if Japanese foreign investment increases as a substitute for exports. These exports, then, will not rise in tandem with the increase in Japanese imports.

To deal with these developments, American negotiators will need to persuade Japanese policy-makers to reduce the current incentives to save, to lower interest rates, to phase out oil-fired power-generating capacity, and to promote retail demand for credit. These actions would complement the commodity- or industry-specific requests the United States already has on the table. Under these circumstances, U.S. goals could be trade-promoting rather than trade-diverting.

Examining each proposed request in turn, a reduction in excess savings is the most critical element. Whereas a high rate of savings was extremely important to Japan after World War II to realize a non-inflationary, rapid investment, high-growth strategy, it has become counterproductive when domestic and export demand in many industries is mature, when the economy has shifted to a high-technology, service sector base, when the world is unwilling to accept massive export outflows from Japan, and when the Japanese government is unwilling to run massive budget deficits. Under these conditions, in order to accommodate a high savings rate, the economy must adjust in order to equate savings and investment, thus inhibiting growth, demand, interest rates, wages, and yen appreciation. A logical solution is to reduce savings by policies such as introducing the green card, imposing taxes on capital gains transactions, and the spending of any tax revenue increases.

Although lowering interest rates would present some unusual difficulties in Japan because of its postal sav-
ings system, it would stimulate demand for housing and consumer durables. At the margin, it would also reduce the incentive to save. Both these developments would clearly stimulate demand and growth, given the current excess savings environment. Income growth would then raise tax revenues, which could be used for more demand-stimulating monetary and fiscal policies— even lower interest rates and tax cuts. Since the domestic economy is considerably larger than the export economy and the external economic environment is depressed, the initial impact of such a domestic economic expansion based on lower interest rates would be to increase imports more than exports. In any case, the MOF can make use of the current fall in U.S. interest rates and in oil prices, which have strengthened the yen, to allow Japanese rates to fall without any real fear of American and European trade officials becoming greatly concerned over “yen rigging,” especially if the import benefit of greater economic activity is stressed.

With respect to further reductions of oil imports, Japan could, over time, help itself and the rest of the world by more rapidly constructing new coal and nuclear power plants while phasing out oil-fired facilities. This would also create substantial new investment demand to use up part of the excess savings without increasing the government deficit. The power utilities would borrow more to fund the program. There would also be few sitting or engineering problems in accomplishing this, as several approved projects have been postponed or scaled down due to the current recession and disappointing economic growth projections for the 1980s.

To achieve this conversion, the government will have to provide the utilities and the oil industry with sufficient incentives to undertake such a program. However, in cooperation with the industries, a suitable package of low-cost or even tax-exempt loans, tax incentives, rate adjustments, and supply contracts could be devised to accomplish the goal. But once enacted, this policy would help to stabilize world oil prices in the 1980s as economic activity revives. An equally important U.S. objective will also be realized, because reducing oil imports allows U.S. commodity imports to increase without depressing the yen and thereby undermining U.S. goals in high technology.

The final recommendation, though at odds with Japan’s postwar institutional policy of channeling savings into productive investment, is that the change in economic realities necessitates the direction of more savings into consumer credit. The ratio of Japanese consumer credit, excluding outstanding mortgages, to personal disposable income in 1980 was only 7 percent compared to 22 percent in the United States.12 There is a great deal to be done here, but one very beneficial step would be the formation of a nationwide credit bureau to pool consumer credit information, a move that the MOF has not promoted thus far. This action would both reduce the cost of credit and free it to fuel consumption demand. Also, the government should move to stimulate the demand for new housing, a major element of new investment demand sensitive

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11. Japan’s postal savings system is a huge source of funds for the government trust accounts, and competes directly with the banks for consumer deposits. As the banks cannot lower interest rates on loans without lowering them on deposits, the MOF must negotiate with the Postal Ministry to lower their rates if depositors are not to withdraw funds from the banks. This is always a political issue focusing on the benefits to the economy from lower rates versus the need for savers to receive an adequate real rate of return.

12. For a good discussion of consumer credit in Japan see Japan Economic Institute, “Japan’s Consumer Credit Market,” JEI Report (Washington, 22 October 1982).
to interest rates with multiple benefits for the rest of the economy. This could be done by offering a five-year tax deduction for interest paid on mortgages for new housing. Furthermore, to avoid renewed land speculation, only the proportion paid for the house would be tax-deductible. As the economic activity generated by a rise in new housing demand would be substantial, the potential loss in tax revenues from the deduction should be largely offset by the rise in revenues resulting from this economic stimulus. The net result would depend on the average tax rate, the current mortgage rate, and the GNP multiplier.

Conclusions

U.S. policy objectives should logically include a low rate of inflation and unemployment, a policy mix that has been elusive in recent years. In addition, the United States should have industries that are competitive in the markets they choose to serve, nationally or globally, while maintaining certain key industries that are deemed vital to the national interest. A critical element in achieving these seemingly contradictory goals is a significantly higher rate of savings coupled with a target set of policies that would favor key industries but would also give them the resources to improve competitiveness. Achieving these economic objectives would provide a firm economic foundation for funding other national goals, including more defense and social services, through a higher real growth rate. It would also reduce unemployment as a basis for many of the trade problems with Japan. But it will require a major effort to stimulate savings since current projections indicate that U.S. government deficit financing could consume 60 to 90 percent of available personal net savings in the 1980s, compared to 10 percent and 20 percent respectively in the 1960s and 1970s. This would leave little or no resources for new productive investment.

At the same time, while such a U.S. program is required to take advantage of a more open Japanese market, it is not sufficient to solve the trade friction problems with Japan. In this regard, the United States must keep pressuring Japan to open its markets to goods and services in which the United States remains competitive and to monitor their compliance under agreements such as the one for Nippon Telephone and Telegraph (NTT) procurement and the recent high-technology accords. For example, the United States should push for the proposed Japanese-depressed industry bill covering areas such as aluminum, paper, and petrochemicals, to accommodate large increases in U.S. imports over time while modernizing Japan's capacity. It should not formalize existing non-tariff barriers. The role and objectives of the Japanese Fair Trade Commission (FTC) in this area are probably similar to those of its American counterpart. In any case, the United States must avoid pressuring for Japanese trade concessions when they have no meaning, for example, opening a market when domestic competitiveness is overwhelming or when other non-tariff barriers are used instead.

However, the United States must recognize that a significant opening of the Japanese market, especially in basic commodities, will tend to weaken the yen and domestic demand unless an offsetting policy can be found. Excess savings have already had a depressing effect on the yen and on economic activity, leading to pressures to export in areas where Japan is already competitive, e.g., steel, automobiles, and consumer electronics. More pressure of this sort is not necessary, especially as an undervalued yen is likely to make the
United States less competitive in the important area of high technology. Because the United States does not just want to substitute a new set of trade tensions for the old, a way of improving domestic Japanese demand and reducing potential exchange pressures from increased imports is called for. The logical complementary Japanese policy requirements are therefore a reduction in interest rates, a substitution of capital for oil, reduced savings incentives, and expanded consumer credit.

Through the above combination of American and Japanese policies, long-run benefits from economic expansion and trade flows can be enjoyed. The alternative is a continuation of trade tensions with Japan. In addition, if the administration does not come to grips with U.S. domestic competitive problems on a long-term basis, it faces the real possibility that extreme protectionist legislation could be enacted. This would only intensify the economic divisiveness which already faces the country in the midst of a major recession. States are actively trying to draw industries away from other states, and are offering incentives to foreign businesses to relocate. Meanwhile, the industrialized East and Midwest continue to lose resources and employment to the South and West. All this aggravates the political and economic environment, including relations with Japan.

The overall U.S. policy goal is therefore to successfully manage these developments while establishing negotiating credibility and improving U.S.-Japanese trade relations. The United States should not allow its free trade idealism to be used against it, nor should it forget that the maximum benefits of free trade are best realized in a full employment environment to which all parts of the world economy contribute efficiently. A balanced and well-targeted policy approach, dealing with the shortcomings and the economic realities of both countries, thus appears not only the best way, but perhaps the only way, through the eye of the policy needle that has proved so elusive thus far.