What the United States Has to Do to Compete with Japan

National resources must be reallocated if the United States is to keep economic pace with Japan.

William V. Rapp
Morgan Guaranty Trust

JAPAN AS A SUPERIOR COMPETITOR

The United States is no longer the world’s leading industrial power. We have not met the competitive challenge of a better organized, more productive, and faster-growing economy, that of Japan. In that, 1978 was a watershed year. At 190 yen to a dollar, Japanese per capita GNP of $9500 essentially equaled that of the United States ($9000), while per capita GNP from manufacturing was 50 percent higher in Japan. Japan had an industrial trade surplus of $77 billion compared to an American deficit of $4.8 billion. Japanese manufactured exports totaled $96 billion, essentially the same as the American $100 billion. Although we have twice the population and GNP, manufactured shipments were equivalent too. In addition, in Japan, absolute gross level of investment was comparable at $340 billion, as was plant and equipment investment ($144 billion to our $148 billion). Investment rates about twice ours and higher real growth rates mean that Japan will clearly pass us as the world’s leading industrial power in the early 1980s despite any exchange rate fluctuations.
U.S. Competitive Weakness

De facto postwar industrial and economic policies would in any case have led foreigners to exploit the competitive weaknesses of America. Japanese firms, however, 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 can benefit the United States only by focusing our attention on American 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 American weakness if sound new policies are not very rapidly developed.

Such tensions could have serious consequences for our important military and political relations with Japan as well. More generally, they would signal continued pressure on the dollar and on our world leadership. Since the policies needed to make us more competitive would reduce many domestic economic ills ("stagflation," unemployment, and competing social objectives), international weakness implies continued domestic economic turmoil. Conversely, a more productive, competitive, and 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 other nations.

The objective here is not to present a full range of national goals and priorities, but only one. We must be able to compete with Japan if we are to maintain the economic base to remain a dominant world power. This must be an important national policy objective, and the benefits more than justify it. Japan needs a strong and predictable ally and we need better Japanese relations, an improved payments balance, a stronger dollar, and reduced world economic tension.

To achieve this goal the United States 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 our 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. It should include a substantial resource allocation shift towards investment, trade, and technology and a change in regulatory policies and in the sharing of regulatory costs. Our current policies are woefully inadequate to meet our competitive problem. Our 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, our overall trade deficit was $7.4 billion and $30.9 billion.

Examining just manufacturing, the situation looks even bleaker, since almost all Japanese exports are manufacturing items, which is not true of the United States. The American overall trade surplus in industrial goods of $20.5 billion in 1975 deteriorated to a $4.8 billion deficit in 1976 while Japan's overall surplus improved from $44.3 billion to $77 billion. The bilateral situation was similar, as the Japanese manufactured goods surplus rose from $7.7 billion to $19.2 billion.

U.S. COMPETITIVE DIFFICULTIES

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

Japan sells little we do not, or could not, make. Yet we have a massive bilateral deficit in manufactured goods, with no discrimination against American manufacturers in our own market. We suffer from excessive importing and declining domestic competitiveness in addition to difficulty in exporting to Japan. Indeed, a Boston Consulting group study for the United States Treasury Department indicates the United States has lost market share in Japan to the European Economic Community and more developed Asia as well.

The lessons are clear-cut. Markets for traded commodities are international, and decreased competitiveness is reflected in all markets, domestic and export. The impact on the deficit is thus doubled as we lose export earnings and increase imports.

The competitive problem is continuing since increased sales improve a competitor's productivity. The Japanese firms with the largest domestic share have the largest export share too. Our marginal firms thus compete with the most successful, most efficient Japanese producer. The market share lost by small American firms in turn helps develop international competitive position of Japanese firms against our lead-
ing producers. Antitrust policy that prevents declining American industries from rationalizing production exacerbates this. The biggest Japanese inroads into domestic and export markets are in industries where economies of scale in production and marketing are important, and where there are small, inefficient producers.

WHAT SHOULD BE DONE

Appropriate competitive policies must offset actions that have raised user costs and lowered normal productivity increases. They must also improve on historical performance. The United States 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 dependent on government policies and initiatives. But we need a different conceptual framework for formulating such economic policy. Policies must recognize that:

• Successful economic policy is a long-term proposition;
• Economies, industries, and markets differ and constantly change and develop, so policies must be both dynamic and industry specific;
• Markets are multinational, so policies must reward competitive success both domestically and overseas;
• Countries have different regulations, so regulatory policies, including antitrust, must be flexible and consider the cost competitive impact of each regulation;
• 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;
• Government interference 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 policies may be so adverse that only a few American firms can develop viable competitive strategies, firms may invest overseas to escape excessive costs, lowering American investment and productivity. We need the new policy perspective to develop an integrated set of initiatives under which our industry can compete with Japan. Yet we must do this within our own institutional, business, and cultural context. In this we are asking not for more government but for more intelligent government and a better quality of policy. Indeed, in many cases we are just asking for more common sense.
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, two to three percent 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

Balancing the Budget

The government should contain expenditures, aiming for 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.

Tax, fiscal, and monetary measures should be coordinated and the government should continue its present policy 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.

Encouraging International Competition

To improve world market share we need to overcome the risks and costs inherent in developing and expanding export markets.

We should introduce specific tax incentives for exports such as a special reserve for overseas marketing costs, accelerated depreciation for export-oriented plant expansion, immediate write-offs for overseas marketing investments, and a rebatable value-added tax.
Potentially we have a comparative advantage in energy-intensive industries. Competitively, Japan and Germany pay more per British thermal unit (BTU) than we do. Our error has been mandating increased costs for oil energy substitutes. (Cost of coal and nuclear generation plants rose 400 percent per kilowatt-hour between 1969 and 1977, of which 300 percent was directly due to regulation.)

A Rational Energy Policy

America needs a rational energy policy that would reverse or offset the producer costs of regulatory constraints that have made alternative energy sources like coal and nuclear power more expensive than oil and gas.

Recognizing Differences Among Industries

Economics, development stages, and competitive requirements of industries change. 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. More than 75 percent 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 are not achieved. Yet the polluter does—not pay, the consumer does—in an inflation tax—and international competitiveness is simultaneously reduced. We must control the cost impact of government regulations on specific industries.

Tax Breaks for Pollution Equipment

The government should allow immediate or very rapid write-offs of pollution-related expenditures. Tax credits might even be considered to compensate for Japan’s competitive edge. Currently three to four percent of our GNP goes to all regulations, but we are only investing 17 to 18 percent compared to Japan’s 30 percent. Competitively, our economy and industry cannot handle the relatively higher diversion of productive resources. Such tax policies would also force lawmakers to make appropriate budget/benefit trade-offs for various regulations.

More government, business, and labor cooperation and less recourse to confrontation, litigation, and multiple licensing would also be beneficial. We might even get more benefit for our regulatory dollars.
Selective Favoritism

The government should pursue selective favoritism according to strict criteria: promoting 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 we should change the 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 antitrust 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 we cannot afford to waste. We must overcome our fear of corporate bigness and take an international 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 stagnation. 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 interrelated and mutually supportive set of actions that make economic sense as a solution to our domestic economic ills, our balance of payments problem, and our 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, and 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. Because we do not live in a policy vacuum there are competitive time pressures. We cannot gradually introduce or postpone such a program. Japan has had a similar one in place for some time with adverse competitive consequences for the United States. While we have printed money to pay for imports, the Japanese have strived for export competitiveness. Quite logically therefore their policies are almost the opposite of ours. Japan views our policies as inadequate.
JAPANESE VIEWS OF U.S. POLICIES

• Floating exchange rates have little competitive impact if fundamentals are unchanged. Large successful 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 hits 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 is true for the United States where rising exchange 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. Changes in the trade balance due to a depreciating dollar without a change in productivity only take place slowly and at the margin. Even worse, they can disguise the need for real policy action.

• American pressures on Japan to grow faster or to liberalize imports have a marginal impact on American competitiveness. Postwar economic history in Germany and Japan shows that imports 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 United States, economic growth has generally been demand rather than supply stimulated. It has, for example, been caused by government expenditures, devaluations and tax cuts, rather than increased investment or productivity. Growth, then, has meant more imports as we ran into supply constraints. We should not, however, project our economic policy difficulties onto others. Currently Japan is pursuing its expansion plans via aggressive monetary policy and more public works (an investment approach similar to past policy). Yet the United States has increased its marginal propensity to import since 1965 from about three to eight percent. This was mostly a result of the Vietnam War and the Great Society programs that led to increased regulatory costs, environmental expenditures, and energy shortages of the 1970s. This has exacerbated and interacted with our compounding inflation rate and a declining dollar.

• A more open Japanese economy or more export-minded American companies will not rectify the situation either. We 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 United States. It is not clear that the problem is the low export consciousness of As over firm.

rage contain would pettibl give cent export.

• At attentive Cour oil is Japan energy low.

• TI sour inwha as a tive

SU?
The qui fun larg Fir anc lut wit is- tiv

no

Ou if t
tia me do
of American firms. The leading 250 American exporters account for over 75 percent of American 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 on their own ground, much less in 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 world market share is more understandable given a rise in Japanese wholesale prices since 1975 of only three percent while American prices are up 21 percent or given that Japanese export prices in yen terms have declined 12 percent versus dollar export prices up 27 percent.

- Attribution of our payments problem, inflation, and loss of competitiveness to oil imports and Organization of Petroleum Exporting Countries (OPEC) is also somewhat misplaced. Our energy prices and oil imports relative to GNP and population remain well below both Japan and Germany. These countries pay higher domestic oil and energy prices while running large payments surpluses and maintaining low inflation rates.

- The current dollar support package does nothing to change basic resource allocations, while higher interest rates potentially discourage investment and, short of a 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 our competitive problem they are inadequate.

**SUMMARY**

The solution to our competitive weakness vis-a-vis Japan really requires a reallocation of our national resources. While Japan has put its funds into investment and technology we have consumed not only a larger portion of our real GNP but some of our existing stock of capital. 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. We have seen no such cooperation.

**Our Fate is in Our Own Hands**

If there is no change in policies then the Japanese competitive differential will 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, and
rising internal dissatisfactions 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, rational and coordinated economic management is both an economic and a political necessity for survival in a competitive world. Such a major change in political economic ideology requires government, business, and labor to work together for national reeducation. The alternative is not attractive for us: increased world economic tensions, declining credibility, and increased internal squabbles over a smaller economic pie. Any analysis of competitive policy interaction has to lead to this conclusion. In the future the Japanese cannot be expected to alter their logical systemic formula for economic success. Our fate therefore remains where it always has been, in our own hands.