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U.S.-Japanese Economic Relations

Statement of
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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the economic relationship between the United States and Japan, an issue of great current interest and concern. Japan is the second largest trading partner of the United States, with only Canada having a larger volume of trade with the United States. The United States and Japan are the largest economic powers on the "Pacific Rim," a region of great economic growth and potential as well as political sensitivity. And, the strains in the economic relationship between the United States and Japan are contributing to the strains that beset the international trading system. Our testimony today focuses on the trade disputes between the United States and Japan and is based on work that we have conducted over the last several years analyzing U.S.-Japanese economic relations and trade issues. A listing of relevant reports and testimonies is attached.

The reasons the economic relationship between the United States and Japan raises serious concerns are well known. The deficit in trade between the United States and Japan, which was $58 billion in 1986, accounted for a significant part of last year's overall U.S. trade deficit of $170 billion. U.S. industry has felt itself on the losing side of many formal and informal Japanese barriers to trade. For their part, Japanese officials point out that Japan has provided the funds to finance the U.S. budget deficit. Japanese question whether U.S. anger with their trade success is poorly disguised frustration that they are doing a better job than U.S. industry in developing, manufacturing, and marketing products and services. They also question whether U.S. industry is guilty of complacent attitudes and inadequate efforts to improve its performance. The Japanese also point to a number of U.S. trade barriers, particularly several directed against Japanese imports, as evidence that the Unites States also does not closely adhere to free trade principles.

The blame for the problems that we confront in U.S.-Japanese economic relations is not one-sided; both nations have an obligation to resolve the problems. The necessary actions are not easy and will require difficult decisions by both nations. However, such actions are in our own national interest as well as the common interest.

SOURCES OF THE CONFLICT

The bilateral trade deficit is perhaps the most visible flashpoint of the U.S.-Japan trade conflict. Although there is no reason to expect a perfect balance in the trade between any two nations, the U.S. deficit on trade with Japan has become very large. To a certain extent, U.S. trade patterns with Japan reflect differences in the natural resources of the two nations; they also reflect differences in the structures of the two economies and in the economic policies of the two nations. The major cause of the overall U.S. trade deficits has been a macroeconomic policy with record-setting federal budget deficits. The budget deficits have been too large to be financed from available domestic savings, thus requiring an infusion of foreign capital. A country importing capital by definition and necessity will run a current account deficit. At the same time, Japan's economic policy has been relatively restrictive as it has sought to curtail its budget deficits, although the growth rate of the Japanese economy has been higher than that of the United States. As a result, Japan is a country with excess savings available for export. And, a country exporting capital will necessarily run a trade surplus. Japan's tax system, furthermore, implicitly encourages savings and discourages some forms of consumption spending.

There are political forces in both nations calling for changes in each nation's economic policies. In the United States, the disagreement has not been whether the deficit should be cut, but how the cuts should be made. The Gramm-Rudman-Hollings law, mandating automatic spending cuts if specified deficit reduction targets were not met, represented an attempt to deal with the difficulty of reducing the deficits. In Japan, there have also been efforts to reorient economic policy to foster higher rates of growth and to lessen that nation's reliance on export-led growth. Policy recommendations from the Keidenren (the Japan Federation of Economic Organizations) have sought a greater policy emphasis on growth, and the commission headed by former Bank of Japan Governor Mayekawa called for an "historic transformation" of the Japanese economy that would lead to domestic consumption, rather than exports, spurring economic growth.

Despite these efforts on the part of both countries, policies have been slow to change. Disagreement about the proper way to cut the U.S. federal budget deficit continues. Japanese Prime Minister

Nakasone has announced a plan for an expansionary economic policy, although many of the details of the plan are as yet undetermined. A new Prime Minister is likely to take office in Japan later this year; many of the details of the policy, particularly with regard to tax policy, may await the new Prime Minister assuming his duties.

While the different economic policies of the two nations have led to the U.S. trade deficit with Japan, Japanese barriers to trade have affected the ability of individual U.S. industries to operate effectively in Japan and are visible irritants that exacerbate problems in the relationship. In recent months, for instance, several issues have been at the forefront of the trade conflict:

- Despite strenuous efforts by the U.S. government and industry, it appears likely that U.S. construction firms will not be able to meaningfully participate in building the Kansai International Airport near Osaka; the total value of contracts for this project may go as high as $8.5 billion. U.S. Government and industry officials fear that the decision by the Kansai International Airport Corporation (KIAC) to restrict bidding to invited participants will eliminate any foreign bidders. KIAC has defended its position by pointing to the large number of potential bidders and the fact that the winner will not have to post a completion bond, creating a perceived need to restrict bidding to firms that it considers responsible.

- Japan's Defense Agency is considering proposals to replace its aging fleet of F-1 fighter aircraft with new fighters, and may decide to design and build an entirely new Japanese fighter in order to promote the Japanese aircraft industry. U.S. government and aircraft manufacturers have claimed that existing U.S.-made aircraft will satisfy the Defense Agency's specifications and requirements. Contracting with Japanese firms to design and build the aircraft, they claim, would be an uneconomical choice.
- In March, the President determined that Japan was not complying with provisions of the U.S.-Japan semiconductor trade arrangement that sought to prevent dumping in third-country markets and to improve foreign firms' ability to sell in the Japanese market. In April, he imposed retaliatory import duties on a range of Japanese products that are imported into the United States. While many in the United States saw the move as a long-overdue response to persistent trade friction with Japan, many prominent Japanese business and government leaders saw the action as one that was driven by domestic politics during congressional consideration of trade legislation.

Other products or industrial sectors in which Japanese barriers have hindered or are thought to have hindered U.S. exports include supercomputers, communications satellites, agricultural products, and leather products.

Why have Japanese barriers to trade been such a constant source of friction? As I mentioned, one reason is the visibility of some of barriers, for example those barriers against agricultural products. Furthermore, the effect of a trade barrier on a particular industry is immediate and clear-cut in most cases, while the effect of economic policy differences, while often more important, is diffused throughout the economy and thus less immediate and visible.

As importantly, the barriers to trade do interfere with trade -- otherwise competitive products are not able to enter protected markets. One key principle of the international trading system is that government interference in trade flows should occur only when necessary (such as requiring product safety standards) or when economic conditions clearly warrant action. Whenever regulations that would restrict trade are justified and imposed, international trading rules call for them to be transparent, that is, the regulations should be well-publicized and the explanation for them clearly understandable. The U.S. complaint is that many Japanese barriers to trade are not transparent or are otherwise questionable under international trading system principles.

U.S. businesses, however, will not be able to sell their products in Japan solely on the basis of U.S. government actions and its diplomatic efforts. There are features of the Japanese marketplace that are not necessarily trade barriers but are difficult and expensive for U.S. firms to overcome. The product distribution system is complex, for example, with more layers of wholesalers than typically exist in the U.S. distribution system. Long-term, complex relationships between buyers and sellers are more common in Japan then in the United States or Europe. The Japanese language is complicated, often adding to the complexity of doing business in Japan. Finally, for a variety of cultural and historical reasons, Japanese consumers are more resistant to imports than consumers in the United States or many other nations.

Foreign businesses, including U.S. businesses, that operate in Japan must make serious and costly efforts to be competitive in a demanding market, and recognize that their efforts can often be more relevant than Japanese actions to reduce trade barriers. In fact, these efforts have paid off for many U.S. firms now operating in Japan. IBM and Texas Instruments, for instance, have had considerable successes in the Japanese market, largely due to substantial, long-term investments there. In consumer products, Schick has a dominant position in the safety razor market. Several U.S. food service businesses also have been successfully franchised in Japan as well, including McDonald's and Kentucky Fried Chicken.

U.S. financial institutions have also begun to make potentially significant inroads into Japan's capital markets. In 1984, the Department of the Treasury and the Japanese Ministry of Finance concluded negotiations that improved access to Japanese financial markets by foreign financial institutions, ensuring that they are accorded national treatment. Several U.S. financial institutions now have seats on the Tokyo Stock Exchange while others are licensed to operate as trust banks in Japan, for instance.

The increasing financial ties between the United States and Japan further demonstrate the importance of resolving the economic problems between the two nations. Capital markets today are international, with markets "chasing the clock" to produce a 24-hour trading day. New York and Tokyo are among the major centers of trading activity, along with London and Hong Kong, and the vast accumulation of savings in Japan ensures the continued importance of Tokyo. U.S. and Japanese financial institutions are among the most important participants in the international capital market, as well.

WHAT SHOULD BE DONE?

While neither side bears the full blame for the conflict between the United States and Japan, both nations have an obligation to act to resolve the conflict. This resolution is in the national interest of both nations and will serve the common interests of enhancing the effectiveness of the international trading system and strengthening the economic and political stability of the Pacific Rim.

Looking first at national economic policies, we believe that it is essential that the United States reduce the federal budget deficit. The reductions should be substantial, but structured in a way that lessens the danger of a recession following the fiscal constraint. On the Japanese side, the Prime Minister's announcement of a stimulative policy package is an encouraging development. The two nations, through coordination of their policies, can do much to resolve the trade conflict.

Over the last several years, most of the attention to the economic policies of the two nations has focused on exchange rates. In the early 1980s, there was great concern that Japan was conducting a policy designed to set the yen-dollar exchange rate so as to give Japanese businesses an artificial trade advantage. After examining this issue, we concluded that there was no evidence to support this belief, although the economic consequences of the then "overvalued" dollar could be severe for individual U.S. businesses that relied heavily on exports or that competed with imports. In the last two years, the dollar has substantially fallen in value relative to the yen and other major currencies.

More importantly, however, we believe that it is essential to recognize that the exchange rate between two currencies is a reflection of the economic policies of the two nations, and not an economic variable that can be set administratively or directly controlled by government decisions. There are valid reasons for governments to have exchange rate management policies, such as seeking to avoid trade losses due to exchange market disorder, but the potential benefits of such policies are limited. These policies cannot be substitutes for necessary changes in fundamental economic policies.

We agree with those who say that Japan should recognize that its role in the world economy has changed and that it would be best served by a more open world trading system and therefore should further reduce its trade barriers. Japan is, and ought to be, judged by a higher standard today than it was twenty or thirty years ago. Japan has justifiable pride in its "economic miracle" and is today one of the largest and most prosperous economies in the world. However, economic success also brings with it greater responsibility for the international trading system and, as a major international financial center, Japan's continued liberalization of its financial markets is essential.

In this regard, U.S. government efforts to negotiate the removal of barriers to trade are important. The United States has generally not sought specific concessions or guaranteed markets for U.S. businesses during negotiations with the Japanese government. U.S. objectives have, in general, been to open markets to all foreign competition. In the MOSS (Market-Oriented, Sector Specific) negotiations, for example, U.S. negotiators sought transparent product standards for the medical devices and pharmaceutical industries and transparent and open procurement practices for the Japanese telecommunications monopoly, Nippon Telegraph and Telephone (NTT), after its conversion to private ownership. Similarly, the benefits of U.S. negotiating efforts to liberalize Japan's financial markets have not been restricted to U.S. banks and other U.S. financial institutions. While U.S. industries were expected to gain as a result of these efforts, competitive industries in other nations should benefit as well. While negotiations that seek open markets are inherently more difficult than those that seek only to guarantee some specific level of sales, they offer more promising long-term improvements in access to the Japanese market.

Negotiations that seek to open markets should result in agreements that can be implemented, verified, and enforced. For example, regarding the U.S.-Japan Arrangement Governing Trade in Semiconductors, the administration's recent actions to impose import duties in retaliation for Japan's not complying with the arrangement was the result of active monitoring by the administration and a commitment to enforce agreement obligations. This case demonstrates how verification and enforcement are essential in any market-opening agreements.

U.S. industry also can further enhance its efforts to cut costs, improve product quality, and market products in Japan. Again, these efforts will take time and may be expensive, but they are essential to establishing or maintaining long-term access to the Japanese market.

While corrective actions, particularly actions to balance our economic policies and efforts to remove the most troublesome barriers to trade, may make substantial contributions to lessening the trade conflict between the United States and Japan, we must recognize that difficult issues will remain. At its best, international trade is inherently competitive and, as two countries with strong and technologically sophisticated industries, the United States and Japan will inevitably compete. The world trading system is based on the belief that such competitive trade is the best way to expand world production and income.

As a resource-poor island nation with a large, well-educated and skilled labor force, Japan probably will continue to be a net exporter of manufactured goods for the foreseeable future. As a result, the United States is likely to continue to import substantial quantities of manufactured goods from Japan. If those imports are brought here by economic forces, and not in response to efforts to "target" U.S. markets, they can contribute to maintaining a high standard of living for U.S. consumers. Similarly, blanket restrictions on Japanese imports would not help U.S. industry but would exact a high cost from U.S. consumers by cutting the supply of Japanese-manufactured goods and by removing the incentive for U.S. businesses to compete with Japanese imports.

While difficult issues will remain, it is essential that we find a way to address and resolve the problems between the United States and Japan. As markets become global in nature rather than limited to a nation or region, international economic interdependence has become an increasingly important consideration in formulating national economic policies. As two of the largest economies in the interdependent world economy, the United States and Japan have a large stake in seeing that our bilateral problems are resolved and that they do not jeopardize international economic growth.

Thank you, Mr. Chairman. I would be happy to respond to any questions you or members of the subcommittee may have.

GAO Reports on U.S.-Japanese Economic Relations

INTERNATIONAL TRADE: Observations on the U.S.-Japan Semiconductor Arrangement (GAO/NSIAD-87-134BR), April 15, 1987

INTERNATIONAL FINANCE: Implementation of the Yen/Dollar Agreement (GAO/NSIAD-86-107), June 3, 1986

Japanese Tax Incentives to Save and Invest; Statement of Allan I. Mendelowitz, Senior Associate Director, National Security and International Affairs Division, before the Joint Economic Committee, September 24, 1984

Floating Exchange Rates in an Interdependent World: No Simple Solutions to the Problems (GAO/NSIAD-84-68), April 20, 1984

Assessment of Bilateral Telecommunications Agreements with Japan (GAO/NSIAD-84-2), October 7, 1983

Industrial Policy: Case Studies in the Japanese Experience (GAO/ID-83-11), October 20, 1982

Industrial Policy: Japan's Flexible Approach (GAO/ID-82-32), June 23, 1982

United States - Japan Trade: Issues and Problems (ID-79-53), September 21, 1979