

Research Department
Federal Reserve
Bank of
San Francisco

April 8, 1983

U.S.-Japan Trade

Recently, Prime Minister Yasuhiro Nakasone of Japan visited the United States to confer with President Reagan on outstanding issues dividing the two nations. Coming within two months of his taking office, the visit demonstrated the importance Mr. Nakasone attached to their resolution. Chief among the issues was that of U.S.-Japan trade.

The discussion on this issue has at times been acrimonious. There is a strong tendency in the United States to blame rising imports, especially those from Japan, for a good share of the business slump and unemployment in this country. Reported difficulties faced by U.S. exporters in penetrating Japanese import barriers have reinforced resentments. Legislation now pending in Congress calls for imposing restrictions on Japanese imports unless Japan agrees to remove its barriers against U.S. exports. On the Japanese side, there is an equally strong sense of outrage directed against the U.S. criticisms. The Japanese feel that they are being unfairly castigated for their superior economic performance in macroeconomic management, product quality, production efficiency, marketing and management expertise.

When emotions run high, issues tend to become distorted and obscured. There is danger that amidst charges and countercharges the two sides might talk past each other and take rash actions to the detriment of both economies. There is, therefore, a need to sort through the issues and examine pertinent facts before attempting to assess the opposing views.

Trade developments

U.S.-Japan trade should be considered in the overall context of U.S. trade with the rest of the world. As shown in the chart, U.S. foreign trade during the last eighteen years can be divided into three periods of six years

each. During the first six years, 1965-70, we had an average overall trade surplus of \$3.7 billion per year. In the same period, our bilateral trade with Japan showed a recurring deficit averaging \$0.8 billion a year. During the second six-year period, 1971-76, our overall trade balance swung between surpluses and deficits but averaged an overall deficit of about \$0.8 billion a year. Our bilateral trade deficit with Japan in that period widened to an annual average of \$3.0 billion. During the most recent six years, 1977-82, our overall trade deficit leaped to an annual average of \$26 billion, while our bilateral trade deficit with Japan increased to \$12 billion a year.

These observations suggest two characteristics of U.S. foreign trade over the past 18 years. First, over the first two-thirds of the period, from 1965 to 1976, there existed a pattern of triangular trade. That is, our persistent annual bilateral trade deficits with Japan were more than offset, or were largely offset, by our surpluses with the rest of the world. As long as this continued, bilateral trade deficits caused little concern.

Second, the pattern of triangular trade disappeared in the late 1970s and early 1980s. Implicit in the data of the past six years is that one leg of the tripod—our surplus with the rest of the world outside Japan—collapsed. We have thus had trade deficits with both Japan and the rest of the world. Indeed, the data also imply that between the 1971-76 and the 1977-82 periods, the deterioration of our trade balance with the rest of the world (\$16 billion a year) greatly overshadowed that with Japan (\$9 billion a year).

Japanese views

The Japanese claim that their success is due to their superior economic performance on both macro- and micro-levels. We examine the facts underlying the claims in three

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areas: unit labor cost, exchange rate, and macro-demand management.

Unit labor cost. Comparing the changes between 1976 and 1981 in wage rates, labor productivity, and unit labor cost (labor cost per unit of output) in domestic currencies as well as U.S. dollars in the two countries yields several conclusions. Over this five-year period, U.S. wage rates rose nearly 60 percent while labor productivity made only small gains. As a result, U.S. unit labor cost increased by about 50 percent. In Japan, because the increase in labor productivity kept pace with the rise in wages (both rising about 40 percent), unit labor costs remained nearly constant.

The relative changes in unit labor costs in the two countries probably contributed significantly to the deterioration in the U.S.-Japan bilateral trade balance which, in turn, might account at least in part for the 33 percent rise in the dollar value of the Japanese yen between 1976 and 1981. However, the yen appreciation in the intervening years was not large enough to offset the relative change in unit labor costs. In 1981, the Japanese industries still had a considerable cost advantage over their U.S. counterparts compared to their respective positions in 1976.

Exchange rates. In recent years, the yen has depreciated sharply against the dollar. From 203 yens per dollar at the end of 1980, the yen depreciated by 27 percent to 277 yens per dollar at the end of October 1982. The sharp yen depreciation gave a substantial competitive edge to Japanese exports in the U.S. market because Japanese export prices rose only 12 percent in the meantime. While this increase exceeded the U.S. export-price increase of 4 percent, it still meant a very large improvement in the price competitiveness of Japanese exports against U.S. exports.

Based on the recent decline of the yen, U.S. producers have complained that the "exces-

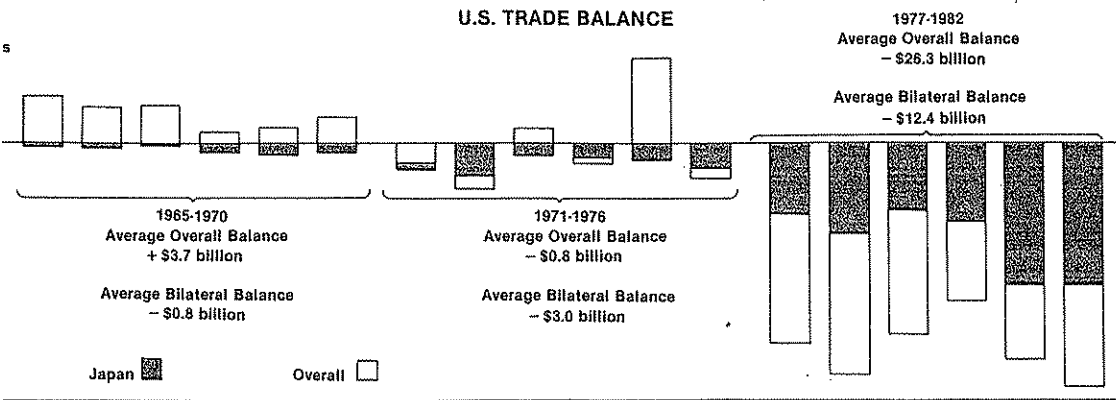
sive" depreciation of the yen against the dollar has shut many U.S. products out of the Japanese market and helped the Japanese products flood the U.S. market. The Japanese contend that the yen depreciation was the result of tight monetary policy in the United States. They blame the policy for driving U.S. interest rates up in comparison to Japanese interest rates and, thus, for causing a capital outflow from Japan. The yen depreciation, from this view, was brought about by U.S. economic policy.

However powerful the effects of yen depreciation in the short-run, it accounts for little of the large shift in the trade balance since 1975. The U.S. deficit with Japan rose from \$1.5 billion in the mid-1970s to about \$18 billion in 1981-82 (see Chart). During that time, the yen appreciated by 30 percent. The long-run deterioration of the U.S. trade balance with Japan must, therefore, be explained primarily by factors other than the exchange rate.

Aggregate demand management. The Japanese argue that one such factor has been aggregate demand management in terms of the rate of spending growth in each country. During the decade prior to 1975, the average annual rate of spending growth (measured by nominal GNP growth) of 16 percent in Japan was double that of 8 percent in the United States. Since then, specifically from 1975 to 1981, Japan drastically cut back spending growth to 9 percent a year to restrain inflation. In the United States, spending growth speeded up to 11 percent a year. The relative shift in demand-management policy is, therefore, claimed as a main cause for the very large shift in the two countries' reciprocal demands for each other's products.

U.S. views

Except for exchange-rate effects, the U.S. side of the discussion does not directly dispute these Japanese views. It rather concentrates on blaming Japanese non-tariff trade barriers to U.S. exports.



Import quotas. Japan maintains import quotas on 27 items, of which 22 are agricultural products and five industrial products. Among these, the United States has been pressing particularly hard for the removal of the quotas on beef, oranges, and orange and grapefruit juices, all of which offer substantial sales opportunities in the Japanese market. However, protracted negotiations have brought about only some liberalization of the quotas, not their total repeal.

Customs procedures. U.S. exporters claim to be frustrated by Japanese customs' arbitrary valuation and examination procedures. For instance, Japanese customs do not have the same provisions as U.S. customs for classifying a product on the basis of prior sample approvals that cover all future shipments from the same producers. A U.S. exporter cannot be sure of how a product will be classified and valued by the Japanese customs inspector until the shipment arrives in Japan. Moreover, the inspectors have wide leeway in determining values and the extent of physical inspection. Until recently, there have been few avenues for appealing the inspectors' decisions.

Testing standards. In order for a product to be marketed in Japan, it must first be subject to Japanese testing to ensure its compliance to Japanese standards. One difficulty this presents is that Japanese standards are written in terms of design criteria rather than performance criteria. For instance, the standard for plywood specifies how plies should be assembled and bonded rather than how the plywood should perform in use. U.S. plywood shipments have been rejected because knots were too large even though there was no evidence that knot size affects strength and durability. On pharmaceutical products, Japanese authorities until recently accepted no foreign test results and required all such products to be clinically tested in Japan on the grounds that the Japanese are physically and metabolically different from foreigners.

Distribution channels. Imports into Japan are dominated by large Japanese trading

companies, and distribution is effected through a tight-knit network of wholesalers and retailers. U.S. exporters complain that because of the traditional "buy-Japanese" sentiment in the group, it has been very difficult to penetrate the market even when U.S. products are better and less expensive. For example, U.S. tobacco exports to Japan are hampered by the fact that distribution of tobacco products in Japan is in the hands of an official monopoly that prices foreign cigarettes at least 50% higher than comparable local brands. This limits American cigarettes to no more than one percent of Japan's \$10 billion market.

In response to U.S. political pressures, the Japanese Government has over the last two and a half years made a number of policy changes to mollify U.S. complaints. A Trade Ombudsman's Office has been set up to hear cases of alleged unfair practices; foreign test results for medicine and cosmetics are now accepted; customs valuation and inspection procedures have been simplified and standardized. In March, legislation was proposed to amend laws on standards and certification procedures that discriminate against imports. But although some strides have been made in reducing sources of friction, there still exists widespread feeling among U.S. exporters and government officials that much remains to be done.

Conclusion
 The Japanese are correct in stating that the large trade imbalances between the two nations are primarily due to basic economic factors rather than any existing trade barriers. At the same time, the U.S. is justified in pointing to the many overt or informal barriers to imports in Japan. Bilateral discussions have yielded significant progress in reducing sources of conflict. Their continuance provides grounds for hope that actual and threatened trade barriers will give way to mutually beneficial expansion of trade between the two nations.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/23/83	Change from 3/16/83	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	162,715	-1,074	4,639	2.9
Loans (gross, adjusted) — total#	141,660	-1,048	4,999	3.7
Commercial and industrial	45,066	- 443	2,874	6.8
Real estate	57,235	- 10	350	0.6
Loans to individuals	23,403	- 14	271	1.2
Securities loans	1,892	- 696	31	1.7
U.S. Treasury securities*	8,096	21	1,798	28.6
Other securities*	12,958	- 47	- 2,158	- 14.3
Demand deposits — total#	38,412	-2,402	1,056	2.8
Demand deposits — adjusted	27,124	- 407	705	2.7
Savings deposits — total	65,086	84	34,387	112.0
Time deposits — total#	68,271	- 219	- 23,606	- 25.7
Individuals, part. & corp.	60,730	- 20	- 21,729	- 26.4
(Large negotiable CD's)	21,549	- 166	- 13,384	- 38.3
Weekly Averages of Daily Figures	Week ended 3/23/83	Week ended 3/16/83	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	107	47		69
Borrowings	31	43		11
Net free reserves (+)/Net borrowed(-)	76	4		58

* Excludes trading account securities.

Includes items not shown separately.

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