

Japan: A Continuing Dilemma for Open Trade Ideals

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Bilateral trade relations between the United States and Japan have been relatively quiet in since 1996. The bilateral focus has shifted to the macroeconomic and financial problems of Japan, as well as the security relationship. More broadly, American trade policy has refocused on getting China into the World Trade Organization (WTO) and starting a new multilateral round of negotiations within the WTO. This paper argues, however, that Japan remains a problem for American liberal trade ideals and trade policy. Continued market access obstacles affect both the specifics of the bilateral relationship—access to Japanese markets for American firms—and broader American support for the WTO and the global process of market liberalization.

The gradual movement toward more open markets for trade and investment, and the domestic political support for that movement over the past half century has depended on a broad sense of reciprocity. One country is willing to lower its trade barriers when it believes that its trading partners are doing likewise, so that the specific losses incurred by domestic businesses facing increased competition from abroad are offset by gains for industries that obtain new opportunities to sell abroad. Through both bilateral negotiations and the series of multilateral trade rounds under the auspices of the GATT, the United States and its trading partners have made considerable progress in lowering barriers since the 1940s. However, the continuation of that process has been seriously jeopardized by Japan over the past two decades.

Both anecdotal and statistical evidence indicates that Japan has not played its expected role in providing reciprocal access to its markets in exchange for more liberal rules of access to the United States or other countries. As American businesses, labor

unions, and other politically active groups because increasingly aware of this problem during the 1980s, American government pressure on Japan to open its markets increased. High profile trade negotiations characterized the second term of the Reagan administration, the Bush administration, and the first term of the Clinton administration, spanning a 12-year period. The knowledge of continuing protectionist Japanese behavior in the face of formal moves to increase market access also eroded the traditional liberal trade coalition in the United States.

The high priority on trade negotiations with Japan through the mid-1990s met with only mixed success, as have the quieter bilateral negotiations of the second term of the Clinton administration. Over the past two years, however, some changes within Japan have led to a new image of a nation that is suddenly more receptive to foreign goods and services. The principal change has been a dramatic rise in foreign direct investment into Japan, driven by the availability of some Japanese corporations for acquisition by foreign firms. The change has been quite startling, with a handful of large corporations being acquired. Just a few years ago, no one would have believed that this change would occur, given the opposition of the Japanese government and the distinct aversion Japanese firms had had to being acquired by foreigners in the past century.

While the apparent change in Japan is a favorable one, it remains far from clear that a fundamental shift is underway. Direct investment into Japan had been so low in earlier years that the increase—while dramatic—implies that the level of investment is still not high. Furthermore, the firms available for acquisition have been predominantly failing firms with no domestic suitors so that foreign acquisition was preferable to bankruptcy. There also remains a distressing tendency to give only a strong minority

ownership to foreigners, a pattern that remains at odds with the preferences of American firms when they make acquisitions abroad.

Furthermore, the trade front remains problematic. Negotiations since the end of the dramatic, high-profile auto sector negotiations in 1994-95 have been quite quiet. But progress has been disappointing and American negotiators remain frustrated. American businesses also remain frustrated over their inability to make progress on specific market access issues. The statistical indicators of market penetration by foreign firms demonstrate that Japan remained less accessible than the markets of the United States or other large industrial nations. The disparity between market penetration in Japan and the rest of the world has diminished somewhat over the past decade, but it remains quite distinctive.

Thus, while access to Japanese markets has not been the focus of much political attention in Washington during the past several years, the problems of asymmetric access to Japanese markets and the sense of an unfair lack of broad reciprocity remain. Whether or not access problems in Japan contribute to the bilateral imbalance in trade, the imbalance remains and will provide a political lightning rod should the American economy slow down and unemployment rise.

This situation matters for several reasons. Japan remains the second largest national economy in the world. Japan continues to be the home of some of the most potent competitors for American corporations in global competition. Japan has formal commitments through multilateral and bilateral agreements that should have provided a much greater degree of access to its domestic markets. Japan's recalcitrant behavior sends a chilling message to other countries (including China) about the possibilities for

complying with the formality of WTO and bilateral commitments while not making real changes at home.

For all these reasons, the continued imbalance in access to Japanese markets remains a problem for mobilizing support in the United States for further trade liberalization. American firms still face problems of asymmetric access in Japan to their detriment, lessening their support for maintaining liberal terms of access to the American market. And more broadly, the knowledge of Japan's ability to continue its protectionist patterns despite a half century of participation in the GATT/WTO undermines American business and labor support for the WTO process.

The following pages explore the current situation in access for trade and investment to Japanese markets. While Japan does not appear to be as much of an outlier among major nations as it did a decade ago, imbalances are far from gone. The concluding section explores the implications of this continuing situation for American trade policy. Much of the material here is based on an update of the author's 1999 book on this subject, which provides more detailed analysis of some of the same points.¹ An appendix to this paper explores the somewhat separate issue of the implications of Japan's high and rising foreign exchange reserves and global current-account surpluses.

Trade in Goods and Service

Trade access to Japan's markets is best subdivided into three areas: primary materials, manufactured goods, and services. Each of these presents a somewhat different picture, although the overall theme is one of continued problems of access in comparison to other countries.

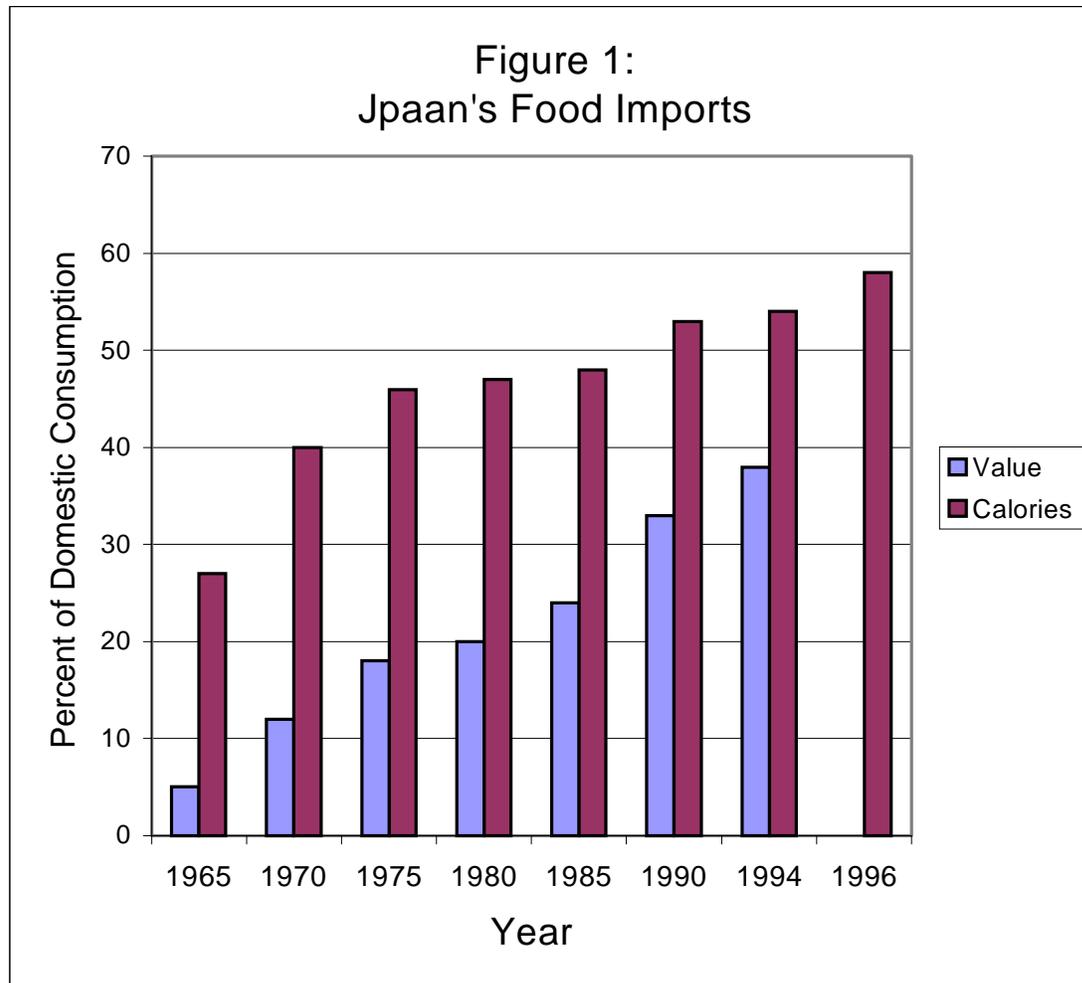
Primary Products. Raw materials have generally faced few barriers in the Japanese market. The Japanese economy has long been dependent on imports of some raw materials because of an absolute lack of domestic sources (including petroleum, rubber, and bauxite). In some other cases, domestic sources involve high extraction costs relative to imports, such as coal. Given the need for raw materials inputs for the manufacturing sector, few barriers affect foreign products. Some exceptions to this general pattern exist, such as subsidization of domestic coal production, but these have been relatively few and have gradually decreased over time. Foreign firms involved in raw material extraction and trade have generally found few problems in selling to Japan.

American and other materials firms face a somewhat different problem in Japan. Many material firms are also involved in processing raw materials, and many of them would prefer to export value-added processed or manufactured materials to Japan rather than raw materials. For many this has been a problem because of the strong bias in Japanese import policies away from manufactures and in favor of unprocessed materials. Petroleum (with total dependence on imported crude oil, but restrictions on refined products until 1998), aluminum (with imports of crude aluminum but few manufactured aluminum products), wood products (with imports of logs but restrictions on manufactured wood products), and iron and steel (with ore imports but low imports of manufactured iron and steel), all fit in this category. Thus, what appears to be a favorable situation with raw materials does mask a problem of market access for those who would prefer NOT to export raw materials. Over two decades of negotiations on forest products, for example, have lowered barriers on manufactured forest products, but they are far from gone.

Agriculture presents a more complex picture. In general, Japan has an inefficient, high-cost agricultural sector that is highly subsidized. Among OECD-member nations, Japan's direct agricultural subsidies are particularly high—the equivalent of \$49 billion in 1998. With subsidies expressed as a ratio to the “farm-gate value” (the actual or estimated pre-subsidy value of the products as they leave the farm), Japan's subsidy ratio comes to 63 percent, a level exceeded by only Norway and Switzerland, and well above the 45 percent ratio for the EU and 22 percent for the United States. Including import protection, the annual real cost to Japanese consumers of domestic agriculture protection and subsidy is a much higher \$73 billion—higher than the \$71 billion cost of European farm subsidies to EU consumers and the \$4 billion cost of American farm subsidies to American consumers.² High subsidies have the implicit impact of protecting inefficient domestic producers against cheaper imports.

Explicit trade barriers are also part of the support for domestic agriculture, but the pattern is very uneven. Some products, including wheat, corn, soybeans, and sorghum are almost entirely imported and barriers are minimal. At the other extreme, the market for rice was completely closed in the postwar period until the government made a minor market opening concession in the Uruguay Round of multilateral trade negotiations in 1994. Rice imports remain minimal. Other products fit in between these two extremes, facing tariff, quota, or other nontariff barriers that have restricted or prevented their ability to enter Japanese markets. Often the barriers have taken the form of phytosanitary standards that have been much stricter than in other countries and without sufficient scientific justification. As with raw materials, some items are imported because no

domestic supply capability exists (including fish and shellfish that do not exist in Japanese waters, or tropical fruits and vegetables that do not grow in Japan).



Source: Management and Coordination Agency, *Japan Statistical Yearbook 1999*, <http://www.stat.go.jp/english/1431-06.htm>, “6-62 Self-Sufficiency Rate of Food.”

Despite the well-known barriers to agricultural imports, reliance on imported food had increased over time, as shown in figure 1. On a value basis, food exports expanded from only 6 percent of domestic food consumption in 1965 to 38 percent in 1994 (the most recent available figure). On a caloric basis, the shift has been from 27 percent of domestic consumption in 1965 to 58 percent by 1996. In very broad terms, therefore, imports responded to the growing relative inefficiency or higher cost of domestic

agricultural products. Despite the difficult negotiations, the presumed political power of Japanese farmers, and the nationalistic rhetoric on food self-sufficiency, barriers have fallen and markets have responded. Both the ratio of foreign agricultural products to domestic consumption and the sustained rise in that ratio stand in stark contrast to evidence on manufactured products presented later in this paper.

The disparity between the value and caloric ratios implies that the bias toward raw materials mentioned above has prevailed in agriculture. The bulk of imports has been in the form of unprocessed products like soybeans rather than higher-value added products (such as frozen food). Even this situation improved somewhat in the 1990s, however, with prepared foodstuffs rising more rapidly than overall agricultural imports.

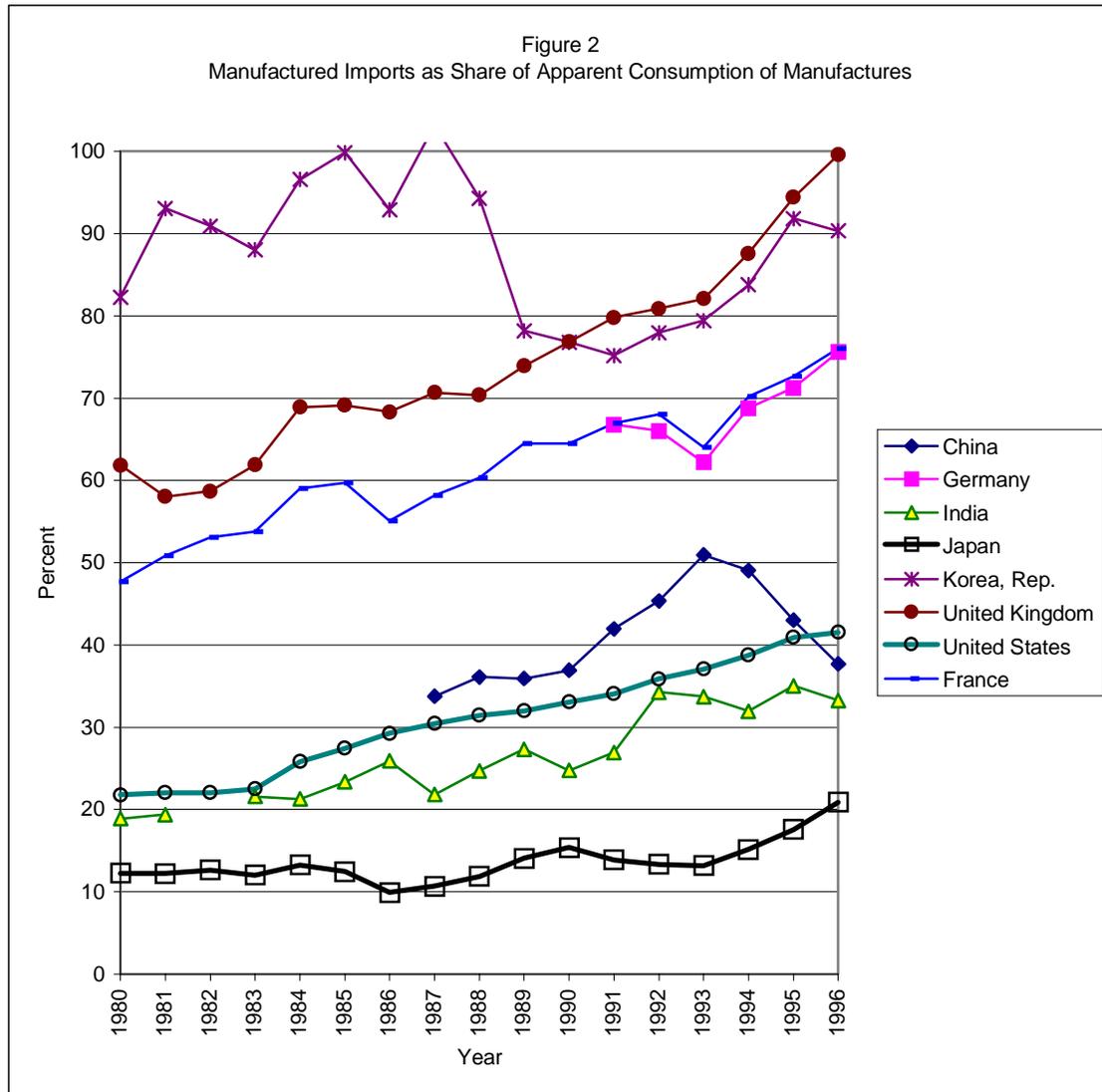
The general trend in food imports does not negate the importance of trade barriers. Although the trend has been in the right direction, at any point in time the role of foreign products would have been even higher if the market were more open. Furthermore, as of 2000, the government was once again declaring an intention to lower the dependence on imported agricultural products—calling for a decrease in the share of imports on a value basis to 26 percent by 2010. While the rhetoric of this policy is covered by language concerning improvement in the efficiency and competitiveness of domestic farm output, the call signals an unwillingness to make markets more open or end the high subsidies that have sustained this very inefficient sector of the economy.³ Unwillingness to alter the basic protectionist stance of official policy was also amply displayed by the Japanese government at the Seattle WTO meeting, where the government's adamant refusal to be flexible on agriculture was a key ingredient in the failure to agree on a new multilateral trade round.

A decade from now, the Japanese government may well have made further trade concessions on agriculture, and the dependence on imported agricultural products may have increased further, despite the current belligerent stance of the government. By adopting this highly negative and visible stance, though, the Japanese government projects an unhelpful image to the outside world and frustrates American trade negotiators.

Manufactured Goods. Over the past half century, the lowering of trade barriers has led to increased merchandise import penetration in most countries. In addition, as firms adjusted to increased international competition, they concentrated more in narrow product ranges (ceding others to their foreign competitors) yielding an increase in what economists call intra-industry trade, wherein nations have both exports and imports within individual product categories. The outlier to this general picture of increased import penetration and increased intra-industry trade through the mid-1980s was Japan. Neither the share of imports in the economy nor the statistical indices of intra-industry trade showed any discernible increase from the beginning of the 1970s through the mid-1980s.⁴

Since that time, some progress has occurred. Both indices have risen, but Japan remains well below the situation in other nations. Figure 2 shows the penetration of imports in several major countries. Penetration is measured by the ratio of manufactured imports to apparent domestic consumption of manufactures (with apparent domestic consumption defined as domestic production, plus imports, and minus exports). The reason for the term “apparent” domestic consumption of imports stems from the fact that imported manufactured goods might be incorporated into other manufactured goods that

are then exported. Therefore, for some nations (such as South Korea) that have very large export industries, this statistic may be somewhat inaccurate. With that caveat in mind, figure 2 shows rather startling results.



Source: World Bank, 1999 World Development Indicators CD-ROM.

As figure 2 shows, this ratio of import penetration hovered around 13 percent for Japan until the late 1980s, but increased to 21 percent by 1996. Although these data are

currently available only up to 1996, separate data on Japan indicate that this ratio has not increased any further by 1999, when it stood at 22 percent.⁵ Even with the increase in import penetration during the 1990s, therefore, the ratio remained well below that of other nations. The United States had an import ratio to apparent domestic consumption of manufactures of 22 percent back in 1980, rising to 42 percent by 1996. Other industrial nations—France, Germany, and Britain—are all much higher still. Even India, a large continental nation (which usually have lower import penetration ratios) with a known policy of protecting domestic industry, had a ratio of 19 percent in 1980, rising to 33 percent by 1996. And Japan's nearby neighbor South Korea has a very high ratio (though presumably much of the imports are assembled into exports rather than consumed in the domestic market).

As nations have lowered trade barriers over the past half century, one of the somewhat surprising outcomes was an increase in something that economists came to call intra-industry trade. Simple economic theory emphasizes comparative economic advantage. Nations generally have a comparative advantage in those goods that use intensively the factors of production the nation has in abundance (relative to other nations). Thus developing countries have an advantage in labor-intensive goods and advanced industrial nations have an advantage in capital and technology-intensive products. Simple comparative advantage theory implies that the bulk of global trade should be between countries with large disparities in factor endowment—especially between industrial nations (with an abundance of capital and technology) and developing countries (with an abundance of labor). However, a large part of global trade in manufactures is among industrial nations that presumably have the same comparative

advantage. What has happened is that industries in these nations have specialized in particular product niches within industries, enabling them to survive in competition with firms in the same industry in other countries. The result has been growth in international trade within narrow industry categories—something that surprised economists 40 years ago and has led to modification of theories of trade.

Most nations have experienced an increase in the extent of intra-industry trade as their trade barriers have decreased, and as their economies matured (with more sophisticated manufacturing firms capable of specializing in niche markets). However, Japan's trade patterns did not move in this direction as its trade barriers were supposedly being lowered from the 1970s through the mid-1980s. As is the case with the import penetration data discussed above, the statistic that measures the extent of intra-industry trade finally rose from the mid-1980s to the mid-1990s. But even with an increase, the extent to which this type of trade occurs remains well below other nations.⁶

Table 1 presents an intra-industry trade index number for all countries whose detailed trade statistics are reported by the OECD. Economists use a statistic that varies in an intuitively obvious way from zero to 100; for any industry, intra-industry trade is zero if either exports or imports within the industry category are zero, and it is 100 if exports exactly equal imports in size. The index numbers for each industry are then summed, weighting them by the size of the industry in the nation's total trade. At the risk of becoming too technical, it is important to realize that for this statistic, low intra-industry trade could result from either low imports relative to exports or the reverse.

Table 1:
Intra-Industry Trade Index Numbers

Country	IIT Index Number	
	1988	1996
Australia	28.2	41.2
Belgium/Lux.	79.3	85.8
Canada	66.0	68.5
China	--	55.5
Czech Republic	--	75.2
Denmark	16.4	77.1
Finland	55.2	63.1
France	85.6	89.0
Germany	69.3	75.5
Greece	34.0	35.5 *
Hong Kong	--	86.4
Hungary	74.3	70.6 *
Iceland	13.2	19.0 *
Ireland	70.6	66.8
Italy	70.4	72.9
Japan	31.0	42.1
Korea	--	59.3*
Mexico	--	77.2
Netherlands	81.9	88.1 *
New Zealand	--	33.5*
Norway	50.7	57.1
Poland	--	50.8*
Portugal	41.0	60.0
Spain	71.8	76.5
Sweden	77.7	74.2
Switzerland	70.6	70.6
Taiwan	--	64.8
Turkey	--	40.3*
United Kingdom	78.8	86.6
United States	72.0**	80.0

Note: * =1995 data; ** =1990

Source: Calculated from data on CD-ROM in Organization for Economic Cooperation and Development, *International Trade by Commodities Statistics ITCS, H.S. Rev. 1 (1988), 1988-1996*.

Japan's intra-industry trade index statistic was up modestly from 31 in 1988 to 42 in 1996, but much lower than that of the United States (72 in 1990, rising to 80 by 1996) or other major industrial nations. In fact, of all 30 countries reported by the OECD for 1996, only five others had an overall intra-industry trade index statistic lower than

Japan's: Australia (41), Greece (36), Iceland (19), New Zealand (34), and Turkey (40). These five countries can be easily explained. They have small populations that limit the scope of the manufacturing sector (especially Iceland), have abundant natural resources and resource processing industries (with less product differentiation and, therefore, low intra-industry trade) that have developed at the expense of other manufacturing industries (especially Australia), have an overwhelming comparative advantage in agriculture that developed at the expense of manufacturing (such as New Zealand), or are still low-income countries with poorly developed manufacturing sectors (Turkey). None of these characteristics applies to Japan, a large mature economy with a well-developed manufacturing sector and a large population. These are all characteristics that should have pushed Japan's intra-industry trade to much higher levels.

What does this mean for American business? Many leading American industries experience rather high levels of intra-industry trade at home; even though they are highly successful export industries, they also face large imports in the American market. These same industries often find that they face a quite different situation in Japan, where intra-industry trade is lower in the same industry, and usually lower because Japan does not import much. Table 2 presents trade data for the 15 largest American export industries.

Most of these industries experience high levels of intra industry in their global trade; they are the 15 largest American export industries, but also face major imports.

Table 2
Intra-Industry Trade (IIT) in Leading American Exports

Description	U.S. Global Trade			U.S. Trade with Japan			IIT Difference (Global - Bilateral)
	Exports (US millions)	Imports (US millions)	IIT	Exports (US millions)	Imports (US millions)	IIT	
4-Digit Industries							
Integrated circuits	32866	33496	99	4029	7654	69	30
Computers and components	25264	39353	78	3293	9356	52	26
Automobile parts	24709	20360	90	1090	6376	29	61
Powered aircraft; spacecraft	20243	4174	34	1500	0	0	34
Office machine parts	18693	21281	94	2292	4498	68	26
Passenger motor vehicles	17490	66217	42	2460	20224	22	20
Aircraft parts	11943	3401	44	1474	766	68	-24
Gas turbines	9112	6065	80	708	234	50	30
Individual function machines	7637	3090	58	1195	1435	91	-33
Nonelectric machinery parts	7583	2273	46	138	452	47	-1
Non-electric medical instruments	7240	3282	62	1370	713	68	-6
Electric apparatus	6477	7205	95	883	1255	83	12
Motor trucks	5993	10380	73	256	767	50	23
Gold	5791	2632	62	71	2	6	57
Radio and TV trans. apparatus	5381	6339	92	351	2650	23	68

Source: Global Trade Information Services, *World Trade Atlas Annual Summary, U.S. Edition (1989-1996)*, on CD-ROM.

Now look at the situation they face in trading with Japan. Most (11 out of 15) face lower intra-industry trade in dealing with Japan than they do globally. And in most cases this is because exports to Japan are considerably lower. Only in the case of a handful of industries like aircraft (a product that Japan does not export in measurable quantities) does the relative lack of intra-industry work to the advantage of American firms. The more common pattern is visible in industries like semiconductors or computers. These industries are the top two American export industries, and on a global basis American imports are just as large or larger than exports. But when these successful industries try to deal with Japan they face a market where Japanese imports are quite low and exports are high.

This disparity matters. Nations and industries are willing to see trade barriers at home diminish when they believe that they are simultaneously gaining better access abroad. But American corporations can see from these trade patterns a general lack of reciprocal access when they deal with Japan. Overall, manufactured imports in Japan are lower (as a share of domestic consumption of manufactured goods) than in other countries, and the extent of intra-industry trade remains much lower than in the United States.

Services. As an excuse for the low level of penetration by imports of manufactured goods, some Japanese academics and officials have argued that Japan has broad comparative advantage in manufactured goods, offset by a comparative disadvantage in service industries. In a very crude sense, this could be true (though it is by no means a believable explanation for the low level of manufactured imports). The notion of a comparative disadvantage in services is supported by the rather rapid rise in services imports and a rising deficit in this trade. Nevertheless, service industries are also an area of considerable anecdotal evidence of trade barriers.

Measuring developments in services trade is complicated by the fact that the data are not as detailed as those for manufactured goods, and some services industries transactions show up as earnings by local subsidiaries rather than trade transactions across borders. Export of entertainment services to Japan by Disney, for example, occur in the form of royalties (from royalties on distribution of movies and ticket sales for Tokyo Disneyland) that are not categorized in balance-of-payments statistics by industry. And export of hotel services to the Japanese may show up as the repatriated profits of American hotel companies that own and operate hotels in Japan.

With these caveats about the data in mind, the general trend for Japan has been for rising services imports and a rising deficit. Table 3 shows the trend in Japan's services trade. Imports of services have risen fairly rapidly relative to the rise in merchandise imports. Services imports in 1980 were 26 percent as large as merchandise imports; by 1999 they were 41 percent the size of merchandise imports. Meanwhile, services exports were only 16 percent the size of merchandise exports in 1980 and that ratio remained almost unchanged at 15 percent in 1999. Thus, in crude terms, the balance-of-payments suggests a rising comparative disadvantage in service industries, reflected in the rising import--relative to merchandise imports and relative to the performance of services exports.

Year	Exports	Imports	Balance
1980	4,625	7,390	-2,766
1981	5,292	8,114	-2,822
1982	5,677	8,541	-2,864
1983	5,225	8,123	-2,898
1984	5,558	8,408	-2,850
1985	5,581	8,443	-2,862
1986	4,145	6,572	-2,426
1987	4,396	7,635	-2,239
1988	4,731	8,871	-4,141
1989	5,810	11,178	-5,368
1990	6,313	12,902	-6,588
1991	6,452	12,433	-5,981
1992	6,558	12,432	-5,874
1993	6,238	11,287	-5,048
1994	6,265	11,406	-5,141
1995	6,157	11,547	-5,390
1996	7,366	14,145	-6,779
1997	8,388	14,931	-6,543
1998	8,165	14,619	-6,464
1999	6,882	13,064	-6,182

Source: Bank of Japan, *Balance of Payments Monthly*, December 1999, p. 18, and earlier issues.

American data largely confirm this picture. Table 4 presents American data on both global services trade and bilateral trade with Japan. The United States has had

rapidly increasing global services exports, and a rising services surplus. The trend with Japan is broadly similar, with the services surplus expanding from \$5.5 billion in 1988 to \$19.5 billion by 1995, before subsiding to \$16.4. Despite these data suggesting a rising services trade pattern consistent with the notion that American service sector industries have a comparative advantage in trade with Japan, substantial evidence indicates barriers to trade.

Year	-----Global-----			-----With Japan-----		
	Exports	Imports	Balance	Exports	Imports	Balance
1986	86.4	81.8	4.6	n.a.	n.a.	n.a.
1987	98.6	92.3	6.3	n.a.	n.a.	n.a.
1988	111.1	100.0	11.1	14.4	9.0	5.5
1989	127.2	104.2	23.0	17.2	8.9	8.3
1990	147.9	120.0	27.9	19.4	10.1	9.3
1991	164.3	121.2	43.1	24.7	12.7	12.0
1992	177.0	119.6	57.4	26.1	13.5	12.6
1993	186.4	125.7	60.7	27.4	14.1	13.4
1994	201.4	136.2	65.2	30.4	15.1	15.3
1995	219.8	146.0	73.8	34.5	15.0	19.5
1996	238.8	156.0	82.8	33.7	14.2	19.5
1997	258.3	170.5	87.8	34.6	15.5	19.1
1998	263.7	181.0	82.7	31.7	15.2	16.5
1999	277.1	197.5	79.6	33.9	17.5	16.4

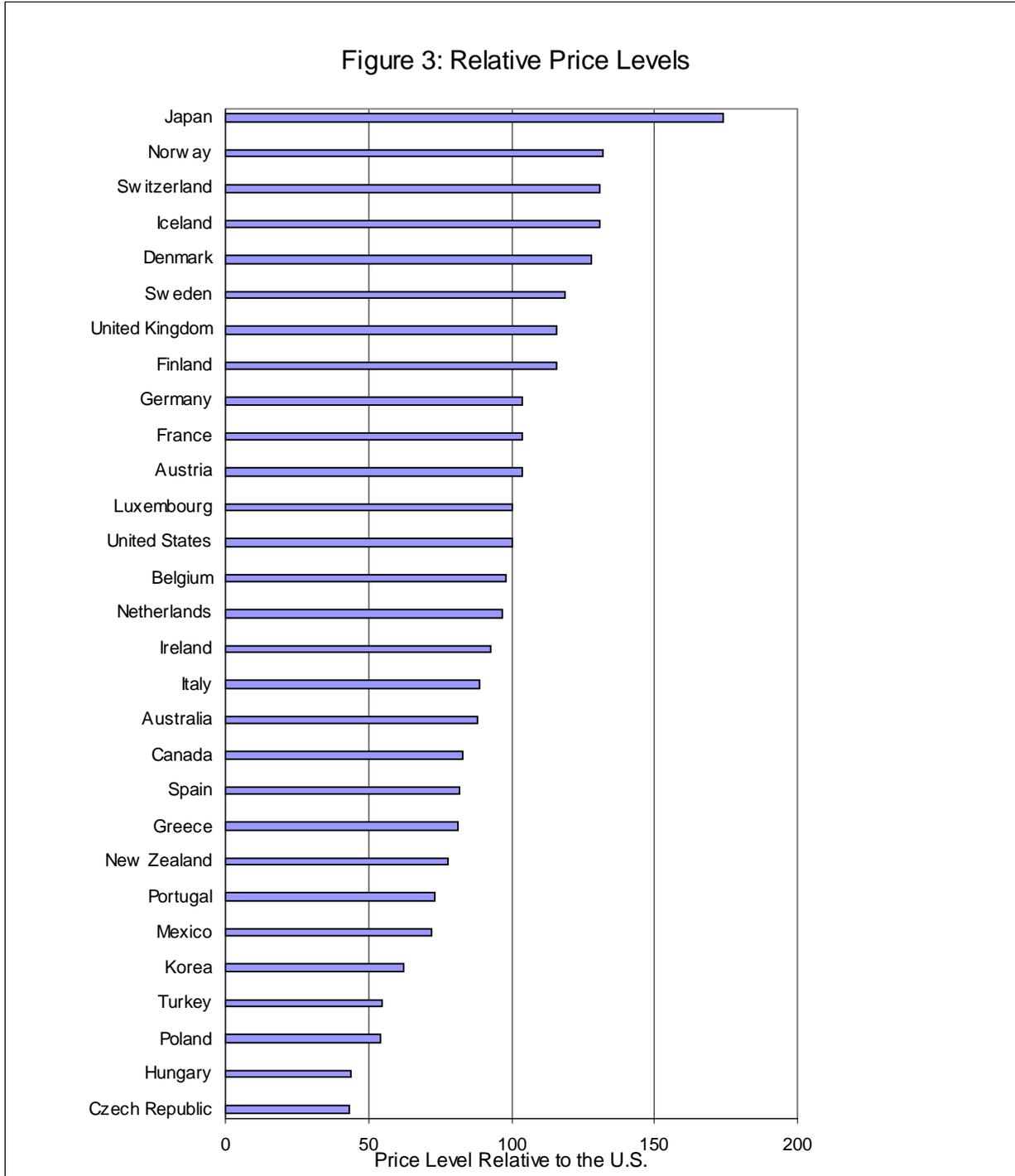
Source: U.S. Department of Commerce, *Survey of Current Business*, various issues, and <http://www.bea.doc.gov/bea/di/bopq/bop1.htm>, <http://www.bea.doc.gov/bea/di/bopq/bop10-4.htm>.

First, consider both tables 3 and 4 again. If Japan has a worsening comparative disadvantage in service industries, why has the growth in services imports largely stagnated since 1990? As part of that overall situation, why have American services exports to Japan largely stagnated since 1995? If the market were open, or becoming more open due to domestic deregulation, then even in the relatively flat economy of the 1990s, services imports should have been increasing.

Second, the anecdotal evidence indicates the presence of substantial barriers to trade in services. Among the bilateral trade disputes concerning access to Japan's domestic market, those in the following industries exposed particularly pernicious barriers and in most cases access issues remain unresolved today: construction, legal services, telecommunications, international civil aviation, and financial services. In the absence of barriers, American exports of these and other services to Japan would be higher and would have grown more quickly.

Prices. One indicator of openness of markets—ranging across agriculture, manufactures, and services—is prices. National boundaries do matter, and exchange rates fluctuate faster than firms adjust prices. As a result, it is reasonable to expect that statistical indicators of national price levels will vary for reasons that have nothing to do with market openness. With that limitation in mind, figure 3 presents data from the OECD on the overall level of prices in 1997 relative to those in the United States for a set of 29 nations.

Of the countries on this list, Japan had the highest prices in 1997, by a wide margin. Japan's overall price level was 74 percent higher in 1997 than prices in the United States, putting it much higher than the next highest country, Norway, which was only 32 percent higher. The extent to which Japanese prices exceed those of other industrial nations is truly startling, though no surprise to anyone who has lived or traveled in Japan.



Source: Organization for Economic Cooperation and Development, *Main Economic Indicators*, <http://www.oecd.org/std/nadata.htm>, downloadable pdf file, "PPPs for all OECD countries".

To be sure, part of the overall price difference comes from non-tradable goods and services (such as housing rents). With limited land area, and a somewhat

dysfunctional set of tax, zoning, and other regulations affecting real estate, land prices are high, and affect overall price levels in the form of high rental prices. However, other detailed price data, some of it from the Japanese government itself, confirm the high domestic prices of goods and services. In 1998, for example, MITI found that the average price for industrial goods and services was 67 percent higher in Japan than in the United States (though they claimed rather unrealistically that manufactured good prices were about equal, with the widest differences occurring in energy and services).⁷

In the absence of trade and investment barriers, high domestic prices should induce an inflow of foreign goods and services, with this arbitrage reducing the disparity. The fact that Japanese prices have remained high, therefore, is indicative of persistent trade barriers through the 1990s.

Negotiations. All of the evidence above concerning the continued disparities in access to Japanese markets is consistent with the difficult negotiating environment that has prevailed over the past several decades. American trade negotiators generally feel that dealing with Japan is more difficult than other nations. The negotiations themselves are often more contentious and more drawn out, and the issues are more likely to be revisited again because the negotiation and agreement failed to resolve the problem. Frustration levels have been high.

The Reagan administration initiated the Yen-Dollar Talks in 1984, aimed at deregulating Japanese financial markets, as well as the Market Oriented Sector Selective (MOSS) talks in 1985. The administration's intensification of the negotiating agenda failed to satisfy Congress, which included the so-called "Super 301" provision in the Trade Act of 1988, mandating that the President identify foreign countries deemed

“unfair” trading partners and initiate a set of negotiations with those countries to rectify the situation. Dissatisfaction with Japan and the frustrating, slow pace of negotiating progress was the principal motivation for this provision. The incoming Bush administration invoked the Super 301 provision with Japan (and two other countries) and also pursued a parallel set of negotiations called the Structural Impediments Initiative (SII). These efforts resulted in some agreements, but the Clinton administration felt the need to continue a high-profile effort to pry open Japanese markets, based on the Framework Agreement of 1993, which established a series of areas that the two nations would negotiate over the next several years. These negotiations proved to be especially contentious, and especially the negotiations concerning access to the automobile and auto parts markets in Japan.

After this prolonged period of relatively continuous, contentious, high-profile negotiations from the mid-1980s to mid-1990s, the Clinton administration proceeded quietly in its second term, with negotiations focused on a variety of deregulation issues in Japan. Even in this less visibly contentious atmosphere, however, American negotiators remain frustrated with the adamantly unyielding stance of their Japanese counterparts and the relative lack of leverage to move negotiations forward. The annual report filed by the Office of the United States Trade Representative with Congress each year on the status of trade problems with various trading partners continues to devote more pages to problems with Japan than with any other country.

This frustration is echoed by the American business community in Tokyo. Their most recent report on the status of American trade agreements with Japan reaches decidedly mixed conclusions. While admitting that some agreements have worked,

creating real improvements in access to Japanese markets, others have not. Their agreement-by-agreement review by the involved industries concluded that only 53 percent of the 63 agreements signed between the two governments from 1980 through 1999 were fully or mostly successful, while the remaining 47 percent fell short. And despite adopting a “cautiously optimistic” attitude about Japan moving toward greater reliance on free-market principles in the future, they argue that government intervention in markets remained the highest in the OECD.⁸

If Japanese markets were as open as the Japanese government claims, or were the government truly supportive of the principles of free trade and reliance on open markets, one would not expect to see the continuing frustration of American negotiators or the negative commentary of those American businesses on the scene in Japan. Admittedly, some members of the ACCJ are less negative; access in some industries has increased and in those areas American businesses have few complaints at the present time. But the overall picture remains rather discouraging.

Investment

Trade tells only part of the story about access to markets. Firms can participate in international markets through trade, direct investment, or both. Put in the simplest terms, a firm can export products from its home market to the world or build those products in the market where they are sold. In this way, investment could be a substitute for trade; by investing locally, products from the local plant substitute for products that had been supplied from the firm’s home country. Applied to Japan, it is conceivable that foreign firms have simply chosen to invest in Japan rather than exporting to it. Sadly, this has

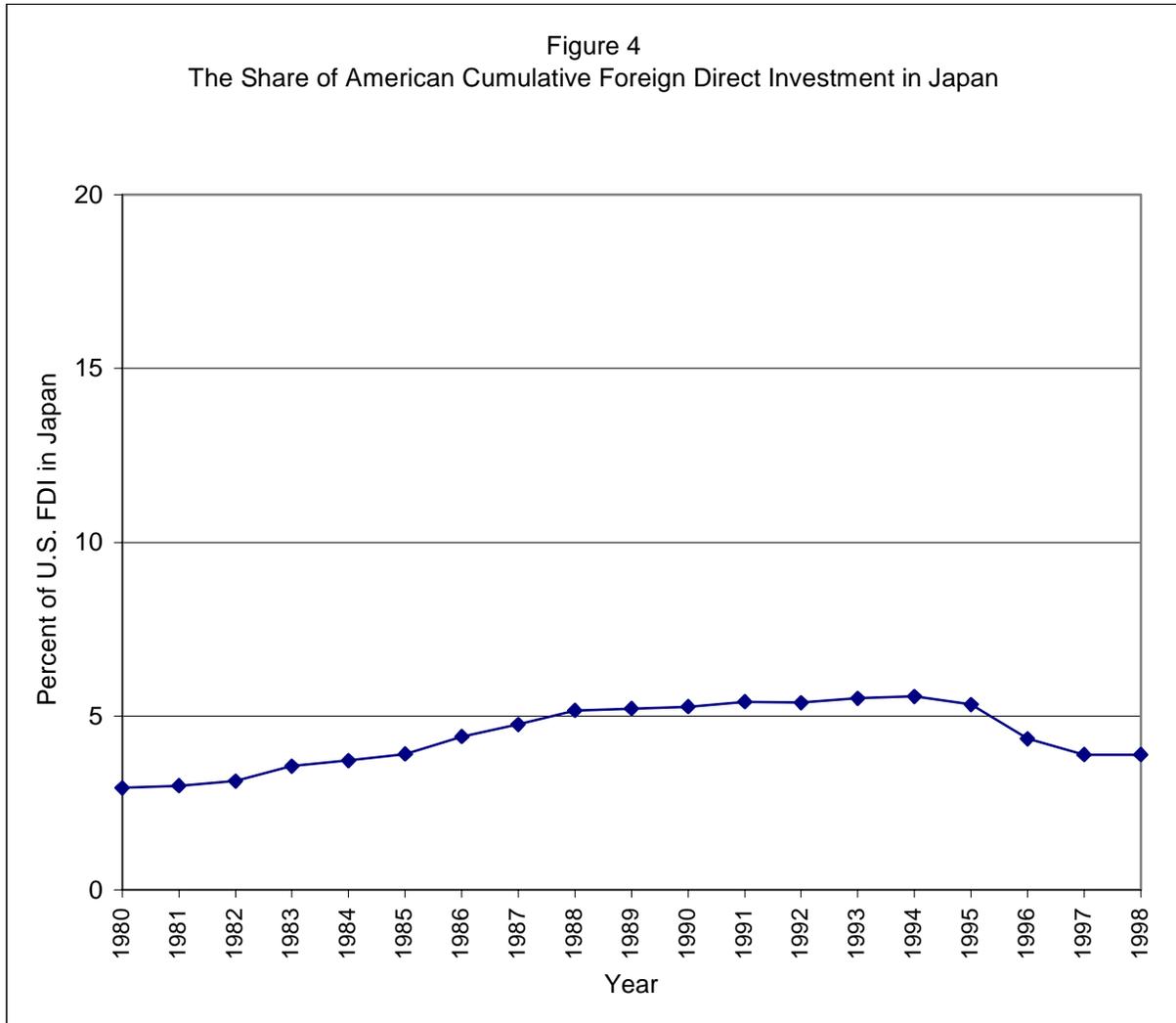
not been the case. Although the data are very imperfect, even a generous estimate leaves the presence of foreign firms in Japan far lower than in other industrial nations.

Most economists see investment as more of a complement to trade rather than as a substitute. Firms that do business abroad, even if primarily through exports, need to invest in a local presence for distribution and after-sales service. Even if they produce goods and services locally, that manufacturing investment presence often sucks in additional imports that would not have occurred otherwise—both inputs for the manufacturing process and additional products that can be sold through the same established distribution channels. Thus, the low level of foreign direct investment in Japan becomes part of the explanation for low imports of goods and services as well.

Early in the postwar period, the government established very stiff investment barriers that kept out investments by most foreign firms. Those formal barriers were dismantled over the period from 1967 to the early 1980s. Even after official barriers fell, though, investment did not rise as rapidly as one might expect.⁹

Certainly many foreign firms do have manufacturing, sales, and/or service facilities in Japan. The American Chamber of Commerce in Japan listed 1,421 member firms in 1995, representing American firms which maintain offices or subsidiaries in Japan. Thus, the Japanese market is certainly not closed to investment.¹⁰

However, the presence of American firms in Japan must be viewed in the context of overall American overseas direct investment. Seen in this context, the amount invested in Japan borders on the trivial. Figure 4 shows that in 1998 the cumulative stock of American investment in Japan was only 3.9 percent of U.S. global investment.



Source: Calculated from data in U.S. Department of Commerce, *Survey of Current Business*, various issues.

Attracted by the dismantling of controls on inward direct investment, which was virtually complete by the beginning of the 1980s, American investment in Japan did expand over the course of the 1980s. Cumulative investment had been only 2.9 percent of the global investment abroad by American firms in 1980 and expanded to 5.6 percent by 1994. But this share subsequently decline, partly due to the decline in the value of the

yen that reduced the dollar-denominated value of American investments in Japan, but also due to a real decline in the flow of new investment.

The share of American direct investment in Japan relative to U.S. global investment remains well below what one would expect given the size and affluent nature of the market. Some foreign investment is motivated by firms seeking low-cost labor. But much of American investment actually flows to other affluent nations, drawn by the similarity in consumption patterns (implying that American firms produce the kinds of goods and services consumed in these nations) and the need to invest where one does business in order to succeed. Consider how large Japan looms in the vision of the outside world viewed by American firms considering where else to do business besides at home. In 1996, Japan represented 23 percent of global GDP minus the United States at nominal exchange rates, or 11 percent even at purchasing-power-parity exchange rates.¹¹ Why should a country that represents so much of the outside world for American firms be the location for only about 4 percent of American direct investments abroad?

Other data confirm the abnormally low level of investment in Japan. In the United States in 1997, foreign affiliates (firms in which foreign ownership of total equity is 10 percent or greater) represented 12 percent of total sales by corporations, and 5 percent of employment. In the manufacturing sector, employment is a much higher 12.3 percent share of total employment.¹² Even though these levels are modest in comparison to the extent of foreign investment in most European countries, they turn out to be much higher than those in Japan.

Comparable data for Japan are unreliable since the government only reports the returns to a voluntary survey. However, there are several ways to estimate the size of

foreign firms invested in Japan. One estimation by economist David Weinstein concludes that the overall sales of foreign-affiliated firms in Japan could be 5.7 percent of total corporate sales, or even as high as 6.0 percent (five times higher than reported by the Japanese government's survey).¹³ A separate way to evaluate the data is to contrast U.S. and Japanese data. The Commerce Department reported cumulative American direct investments in Japan to be \$38 billion in 1995, or 2.4 times larger than the \$16 billion reported by the Ministry of Finance. The Commerce Department data deal with most of the problems that plague the Japanese data. Applying this adjustment factor to total foreign investment in Japan, foreign firms would represent 2.9 percent of corporate sales and 1.2 percent of employment. Therefore, Weinstein's estimate should be considered a generous upper bound on the possible size of foreign direct investment in Japan.

The bottom line is that as of the mid-1990s, foreign-affiliated firms represented a much smaller share of the domestic economy than is the case in the United States, even if one makes generous assumptions about the data. Since all the official barriers have been eliminated, why has there been so little investment into Japan? Some academics and Japanese government officials have argued that a combination of cultural factors (such as language) and the unattractiveness of Japan as a location of investment after wages rose to high levels provide the explanation. They do not. As argued above, much of American investment flows to developed countries, not low-wage developing countries. Language could be a partial answer, but this doesn't explain why American and other foreign firms have flocked to non-English-speaking countries like China.

The real answer lies in two problems. First, foreign firms have long assumed that investment in Japan would not enable them to overcome market access barriers. The

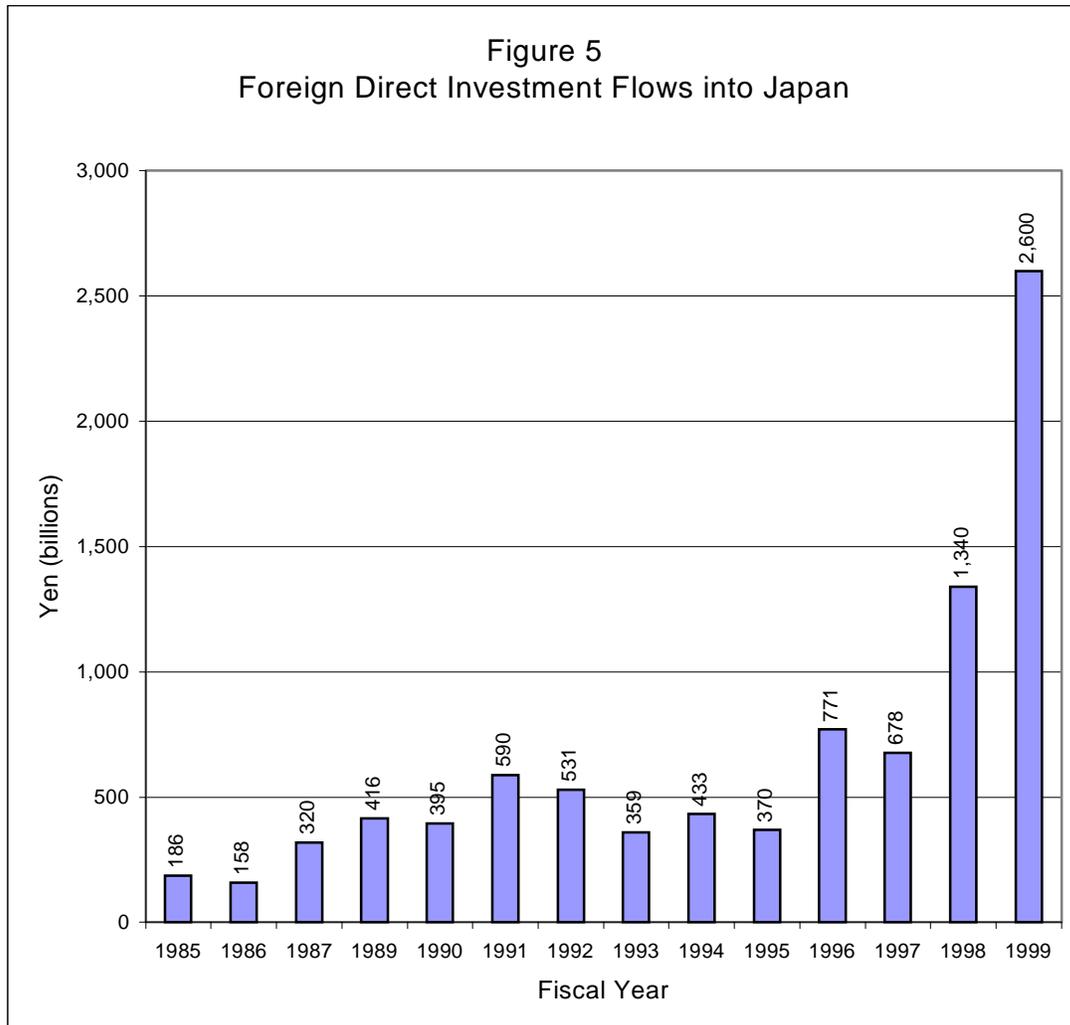
nature of barriers for foreign firms extends well beyond problems at the border such as tariffs and quotas. When foreign firms perceive that they face problems of peculiar standards or collusion in the market place, then actually investing in Japan does not solve their problem.

Second, a favored method for firms to invest around the world has been acquisitions. An acquisition provides a firm with instant local expertise. But in Japan acquisitions have been very difficult. Until the 1970s, foreign firms faced regulations that prevented them from acquiring majority ownership of local firms. Even since those days, unfriendly takeovers have been completely unknown, and friendly takeovers by foreign firms have been relatively few in number. The managers of Japanese firms, plus their principal lenders, business partners, and major shareholders, have all shared an aversion to being acquired by foreign firms. That aversion was also shared by the government—a government that had pursued a century-long goal of building an industrial nation owned and operated by domestic firms free from the control or influence of foreigners.

The low level of direct investment into Japan has been on the bilateral government negotiating agenda for over a decade. Those discussions have produced little. Over the years, the Japanese government has introduced a variety of small promotional programs to encourage foreign investment into Japan, but none of them addressed either of the two main obstacles. At the margin, these programs did not harm, but have been largely irrelevant.

Has this situation now changed? Optimists point to the recent dramatic surge in foreign direct investment into Japan and argue that all the comments just made are no

longer true. Figure 5 illustrates the dramatic change. Prior to 1998, the annual inward flow of direct investment as reported by the Ministry of Finance had never exceeded ¥800 billion. In fiscal year 1998 (April 1998 to March 1999), the level doubled from the previous year to ¥1.3 trillion, and in fiscal 1999 almost doubled to ¥2.4 trillion



Note: fiscal year 1999 is an estimate based on the data for the first half of the year (April-September 1999).

Source: Ministry of Finance, Okurasho Kokusai Kin'yukyoku Nenpo, No. 14, 1990, p.447, 467; No. 16, 1993, pp. 483, 504; and <http://www.mof.go.jp/english/fdi/e1c008f5.htm>.

. At current exchange rates, the fiscal 1999 inflow was the equivalent of \$22 billion. Accompanying this dramatic increase has been a flurry of large, highly visible

foreign acquisitions of Japanese firms. Is this finally a revolution that is ending the unusual lack of foreign penetration of Japanese markets? Maybe, but probably not.

First, consider that the dramatic increase is occurring from a very small base. In 1998 (the most recent data available), the flow of direct investment into the United States was \$188 billion—*eight and a half times* higher than the level in Japan in fiscal 1999. Admittedly, investment into the U.S. has also surged in recent years, from \$45 billion back in 1994. The fiscal 1999 inflow into Japan represents 0.5 percent of GDP, while the U.S. inflow in 1998 represents 2.1 percent of GDP. Back in 1994, the \$45 billion inflow to the United States represented a much lower 0.6 percent of GDP, close to the current level in Japan. If compared to that earlier level, the FY1999 inflow in Japan begins to approximate what one might expect in an open environment. But if this sudden surge turns out to be a temporary peak (comparable to what may be an unusual peak in inflows to the United States in 1998), then the longer-term picture will be one in which inflows as a ratio to GDP remain below American levels. More importantly, the annual flow of investment into Japan would actually have to *exceed* American levels (as a percentage of GDP) if the low level of the stock of foreign investment relative to the situation in the United States or other countries were to diminish substantially. This is not happening yet. Even assuming that fiscal 1999 inflows turn out to be as large as assumed, this would still leave Japan with a cumulative value of inward direct investments of less than the equivalent of \$90 billion. In contrast, cumulative direct investments in the United States totaled \$812 billion—roughly ten times as large.¹⁴

Second, while the surge is encouraging, it remains entirely unclear whether it represents a new trend or a temporary blip. As noted above, part of the current

phenomenon has been acquisition of existing Japanese firms, another encouraging development. But most of the firms featured in the media have been in extreme distress—either bankrupt or facing imminent bankruptcy. The Long-term Credit Bank (acquired by Ripplewood Holdings) was bankrupt and nationalized by the government; Japan Leasing (acquired by GE Capital) was bankrupt; Yamaichi Securities (whose retail outlets were acquired by Merrill Lynch) was bankrupt; and Nissan (acquired by Renault) was in immediate danger of bankruptcy. For these firms and the government, acquisition by foreign firms was a preferable outcome to closure, especially considering that other Japanese firms showed no sign of interest in making the acquisition themselves. This suggests that the surge in investment could be a temporary phenomenon caused by the recession of 1997-1999 and the extreme financial distress facing some Japanese firms. Should the economy recover, it is quite likely that potential acquisition targets will disappear as Japanese stakeholders revert to their aversion to foreign takeover.

Third, the nationalist aversion to foreign takeover is far from gone. The Long-Term Credit Bank was sold to Ripplewood Holdings by the government (which was charged with cleaning out the bad assets from the bankrupt, nationalized institution and selling the remains back to a private-sector owner). Even that sale occurred even after government efforts to solicit a credible bid from Japanese sources failed. However, having made the sale, the other large, nationalized bank, Nippon Credit Bank, was rather pointedly sold to Japanese owners. Participants in that process have openly admitted to the press that selling one large bank to foreigners was as much as they could stand. While attitudes about foreign firms as owners of substantial assets in Japan is certainly

not as xenophobic as it was a decade or two ago, clearly they have not been erased and could re-assert themselves, pushing the pace of acquisitions back down.

Finally, a somewhat disturbing tendency toward minority ownership stakes remains in place. When firms make acquisitions abroad, their preference has been to acquire a controlling interest of at least 51 percent. This has certainly characterized the behavior of American firms when they have invested overseas.¹⁵ Historically, however, foreign firms have been either prevented (prior to the 1980s) or less successful in gaining controlling shares in either acquisitions or joint ventures. In 1997, for example, American multinationals reported that 86 percent of their total overseas affiliate assets were in majority-owned subsidiaries, compared to only 67 percent of their assets in Japan.¹⁶

Anecdotal evidence suggests some continuance of this pattern. Several of the prominent recent acquisitions in Japan still fall in the minority-share category. Ford increased its minority ownership of Mazda, but it remains at only 37 percent; Renault acquired 37 percent of Nissan; General Motors has acquired 20 percent Subaru; and Daimler-Chrysler 20 percent of Mitsubishi Motors. The press has suddenly touted the importance of large minority ownership stakes, since 33 percent is a threshold above which an owner has veto rights over certain basic board decisions. Veto rights, however, are a far cry from a controlling interest, as numerous foreign firms have discovered to their chagrin over the past half century. Ford may well fold Mazda decisively into its corporate structure (by convincing Mazda to base its future cars on Ford platforms), but the general picture is a somewhat discouraging disparity between the media or public relations position about foreign acquisitions and the reality of a pattern of continued minority ownership.

Japan at the turn of the decade has been in some economic distress for several years. The severe financial difficulties of some firms, combined with the lack of interest or ability of other Japanese in acquiring them has produced the surge in inward investment. But the underlying anxiety about foreign control remains, and that anxiety explains the continued efforts to hold foreigners to minority ownership positions in many cases. The Japanese firms (and the government, which watches the situation closely) want or need both financial infusions from abroad and some changes in management in order to survive. Having made bad decisions over the course of the 1980s and first half of the 1990s that got them into financial trouble, these firms find it convenient to have the foreigners make the necessary but unpleasant decisions to unwind the mistakes. But it is not clear that these firms (or firms in the economy more broadly) want long-term foreign control. That is, once the mistakes are rectified, foreign investors could well find their role or influence in the daily decision-making of the firm greatly reduced should they have less than a controlling interest. This is somewhat similar to the situation in the 1950s, when Japanese firms desired foreign-owned hard technology and sometimes had to accept partial ownership as the cost of acquiring that technology (as was the case in the oil refining industry). The foreigners thought they were gaining corporate control, but discovered that they had only a minor role once the technology was transferred and the domestic joint venture was a going concern (often with a lower dividend pay-out than the foreign owners desired).

For all these reasons, the encouraging upturn in the official data should be viewed very cautiously. At the moment, the surge has suppressed the frustration of foreign firms as they scramble to take advantage of the current situation, and the stories of highly

visible acquisitions that pervade the press present an image of a changed environment. If the above caveats are correct, however, the surge in foreign direct investment into Japan will not last at its current high level, and the frustrations of foreign firms will reassert themselves.

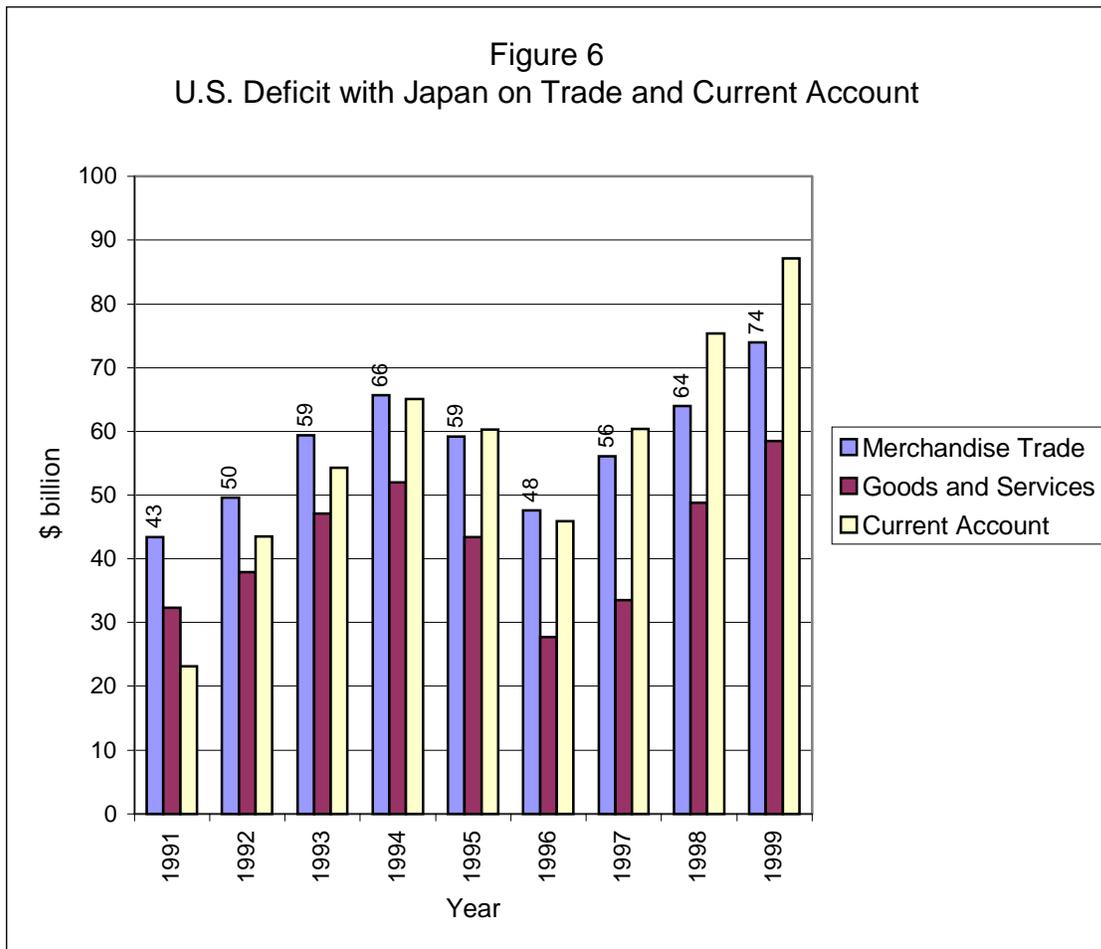
Conclusions and Implications

A decade ago, the combination of extensive market access problems in Japan, that nation's continued overall economic success, and the rapid penetration of Japanese firms into the American market created a sense of alarm in the United States. How could groups in the United States justify pushing for lower trade barriers, or resist calls for protection when Japan was such an egregious exception to the global pattern of falling market access barriers and seemed to be prospering so much from its ungenerous behavior. Those days are gone. The Japanese economy has been stuck with low growth (averaging only one percent annually from 1992 through 1999, and punctuated by recessions in 1997-98 and again in the second half of 1999) and a mountain of non-performing bank loans. Japanese firms that appeared to be gaining a strategic trade advantage by using the excess profits generated from a closed home market to subsidize their advance overseas have stumbled and generally lost global market share in the 1990s. In new areas of information technology, most of the indicators place Japan well behind the United States in both the state of technology and its diffusion within the economy.

Given all these problems that have diminished the image of Japan, it is tempting to say that the status of access to Japanese markets does not matter anymore. Certainly bilateral trade issues have been largely out of public sight since the end of the raucous

negotiations over access to the markets for automobiles and auto parts in 1995. But it would be a mistake to assume that these access problems have become irrelevant.

Consider first what has happened to the bilateral trade and balance of payments imbalance. Figure 6 provides data on the annual American deficit with Japan during the 1990s for merchandise (goods) trade, goods and services, and current-account. After



Note: Merchandise trade balance is based on exports measures f.a.s. and imports c.i.f. (i.e. not on a balance of payments basis); goods and services, and current balances are based on balance of payments data.

Source: U.S. Department of Commerce, "U.S. Total Trade Balances with Individual Countries, 1991-99," <http://www.ita.doc.gov/td/industry/otea/usfth/aggregate/H99t08.txt>; and U.S. Department of Commerce, *Survey of Current Business*, March 1993, p. 105, March 1994, p. 83, March 1995, p. 95, April 1996, p. 85, April 1997, p. 59, April 1998, p. 95, and April 2000, p. 189.

peaking at \$66 billion, the bilateral U.S. merchandise trade deficit shrank to \$48 billion by 1996, under the influence of a strong yen (weak dollar) and perhaps the effect of a decade of market-opening negotiations. But with the yen weakening after 1995 and Japanese economic growth stalling after 1996, combined with continued strong economic growth in the United States, the imbalance has widened again to a record \$74 billion in 1999. In the past, this number has been the most closely watched bilateral indicator in Washington.

The bilateral merchandise trade imbalance has been criticized for being too narrow a measure of bilateral economic interaction. However, figure six indicates that both the balance on goods and services and the current account (which adds the flow of repatriated earnings on investments, and unilateral government transfers, to goods and services) closely track the developments on merchandise alone. The United States does have a bilateral surplus with Japan on services transactions, so the goods and services imbalance is consistently smaller than that on goods alone. But after bottoming out at \$28 billion in 1996, the bilateral deficit on the basis of this broader measure had ballooned to \$58 billion by 1999. Despite the widespread perception that American service sector firms have a strong competitive advantage over their Japanese counterparts, the surplus the United States has had with Japan on services trade has been shrinking since 1997. And after the unusual year of 1991 (when the Japanese government transferred \$14 billion to the U.S. government in support of the Gulf War), the bilateral imbalance on the current account has been as large or larger than on merchandise alone. The current-account imbalance reflects the much higher level of

Japanese investment in the United States and the higher interest rates in the United States than Japan, producing an American deficit on the flow of repatriated investment earnings.

As indicated by the description in the previous paragraph, economists would not argue that this imbalance widens or shrinks on the basis of developments in trade barriers. Nevertheless, macroeconomic statistics, such as trade imbalances, are influenced by microeconomic factors, such as trade barriers. Would the bilateral imbalance with Japan fall in the absence of trade and investment market access problems? Probably. How much it would fall cannot be predicted because of complex interactions in the economy (with, for example, rising imports in Japan potentially blunted by a falling yen).

By itself, the size of increase in bilateral imbalances on merchandise trade, trade in goods and services, or current account should not be the prime motivator of American trade policy. Nevertheless, the imbalance does provide an irritating statistic, especially at times when the U.S. economy is in recession. Should the long upswing in the U.S. economy of the past decade diminish or even turn to recession in the next several years, while the bilateral imbalance continues to climb, this statistic will once again become politically sensitive. At the present time, with very low employment, it is difficult for any organized group of workers, corporations, or politicians to complain about a loss of American jobs to the Japanese, but in an environment of rising unemployment, that charge is likely to resurface.

Note that the issue is not the bilateral trade imbalance *per se*; it is the trade imbalance coupled with the evidence of obstructed market access in Japan. If American business and labor were convinced that Japanese markets were as open as those of other

nations, then the bilateral trade imbalance would be largely ignored. This statistic attracts attention because it is such a convenient symbol of the lack of access to Japanese markets, even when those who use the symbol know that removal of those barriers would not eliminate the imbalance. Why should a nation like Japan, that has large global and bilateral trade surpluses, need to maintain protectionist policies? Shouldn't such nations be among the leaders-by-example in the global movement for more open trade—as Great Britain was in the mid-19th century and the United States was in the early postwar period? Because Japan does not fit these expectations, the bilateral trade imbalance becomes an understandable symbol of American frustrations.

Japan is also important to American trade policy discussion because of its sheer size. Despite a decade of relative stagnation, Japan remains the second largest economy in the world. While the reality of the size of Japan's economy is better expressed by its 9 percent share of global GDP at purchasing-power-parity exchange rates than its 17 percent share at nominal exchange rates, it is the second largest national economy in the world.¹⁷ And Japan is an affluent market, meaning that it consumes the kinds of goods and services that American firms excel in producing. Overall, 47 percent of American exports go to the affluent developed countries of the Europe, Canada, and Japan.¹⁸ At purchasing power parity exchange rates in 1997, *per capita* GNP in Japan was 84 percent the level of that of the United States, putting it slightly ahead of Germany (76 percent) and France (73 percent).¹⁹ Therefore, the state of access to Japanese markets should matter because of Japan's relative size and affluence in the world.

In addition, Japan remains the home base for many of the key global competitors for American firms. The record of the past decade does suggest that the predictions of

strategic trade theory were exaggerated—using a protected home market to generate high profits does not always translate into success in grabbing market share abroad.

Nevertheless, firms do gain at least some advantage from doing so. The government-owned telecommunications giant—NTT—may be preparing for doing exactly this.

Regulation that has saddled Japanese consumers with high telephone bills and potential competitors with absurdly high inter-connect fees, has built excess profits for NTT which it now appears to be readying for use in making acquisitions abroad (participating in a global restructuring of the telecommunications industry from which NTT has been singularly absent in the past several years). At the moment American firms do not appear particularly troubled by the home sanctuary policies of some of their Japanese competitors, but this situation may not last.

Issues of access to Japan are particularly frustrating because the Japanese government has been a signatory to every major multilateral trade liberalization measure of the past 35 years, plus some 63 bilateral trade agreements with the United States since 1980. That the ability to penetrate Japanese markets should remain circumscribed relative to the sense of access to other markets around the world despite this history of formal market opening is galling. The formal opening—lowering tariffs to low levels, removing quotas, and a blizzard of other surface changes in regulations—have provided the Japanese government with a convenient façade behind which it can hide, declaring publicly that markets are open.

Obstructed access to Japanese markets matters more broadly because it sets an unfortunate precedent for other countries. If developing countries perceive that the Japanese government can keep domestic markets less open than is the case in other

industrial nations, they may be encouraged to follow the same path. One major element of the "Japanese model" of development was heavy trade and investment barriers. Countries in the Asian region are certainly acutely aware of the ability of Japan to maintain a façade of openness while pursuing a reality of protectionism.

This problem of the lessons provided by Japan extends in a disturbing way to the World Trade Organization (WTO). In principle, the WTO is a multilateral institution that enables more rapid progress toward an open trade and investment regime for the world. The WTO provides the venue for multilateral trade negotiation rounds that have accelerated the pace of lowering barriers over the past half century. The WTO also provides a set of procedures for adjudicating disputes over existing commitments, and for retaliating against countries that do not abide by their commitments for more open markets. But the behavior of Japan within the WTO (and the previous GATT) sends a chilling lesson to other nations in several ways.

First, developments in the bilateral relationship send a clear message to other nations that the United States has lost the will to use so-called unilateral retaliation under Section 301 as a negotiating tool. Generally disliked abroad, Section 301 has been useful tool for prodding countries toward greater openness by threatening retaliation on a quicker schedule and with greater certainty than is the case with WTO dispute cases. The obvious reluctance of the U.S. government to follow through with its Section 301-based tariff on Japanese cars in 1995 when the Japanese formally protested to the WTO is a highly visible lesson. Lobbyists for foreign countries in Washington will hear from any number of administration sources that Section 301 is a dead letter. In the larger scheme of historical development, strengthening multilateral institutions and rules at the expense

of national autonomy may have been inevitable in the arena of trade policy, but the Japanese (and European) effort to undermine Section 301 during the Uruguay Round negotiations, and the subsequent overt challenge by the Japanese government in the auto dispute means that the United States has lost a useful bargaining chip in prodding the world toward a more liberal trade and investment regime.

Second, the Japanese government has correctly perceived that it has a better chance of delaying or resisting American pressures for trade liberalization by pushing the U.S. government to use the WTO dispute-resolution mechanism. Because most access barriers in Japan are opaque or involve murky unwritten relationships between government and the private sector, a quasi-judicial system relying on hard printed evidence and panels unfamiliar with the nuances of industrial policy in Japan are poorly equipped to handle Japanese cases. This problem was painfully obvious in the color film case; the access barriers documented by the U.S. government seem quite obvious to anyone with extensive experience with Japanese government-business relationships, but they were too nebulous for the WTO. Japan is not the only nation--especially in Asia--where the relationship between the realm of government and the private sector is very vague, and the lesson of the color film case will not be lost on Japan's neighbors. The sad result is that the WTO dispute resolution mechanism may become a means for these nations to validate their protectionist behavior.

Third, Japan has sent negative signals about the usefulness of the WTO in actually slowing the pace of new commitments on trade and investment liberalization. Neither the GATT nor the WTO mandates a multilateral bargaining process. However, the Japanese government has sent clear signals that it intends to ignore strictly bilateral pressures for

market access liberalization if at all possible, pushing those issues to a multilateral round. Simultaneously, the Japanese government has acted as an obstructionist force in beginning a new multilateral round, and should that round start Japanese negotiators will undoubtedly play a prominent role in drawing out those negotiations for a very prolonged period of time (as they did in the Uruguay round).

In all these ways, Japan has stood the principles of the WTO on their head. For Japan, the WTO represents a means to delay, diminish, and deflect American and other foreign pressures for more liberal access to its domestic markets through trade and investment. Japan has successfully attacked the American alternative of bilateral negotiations and has then manipulated the multilateral system to the detriment of progress on trade and investment liberalization. This is an unfortunate development.

Questions of access to Japanese markets have not attracted much attention during the last several years. But this paper has demonstrated that Japan remains an outlier—with unusually low levels of import penetration, intra-industry trade, and inward direct investment. To be sure, the situation today is not as distinctive as it was 15 years ago; imports, intra-industry trade, and inward direct investment have all moved upward to modestly diminish some of the disparities that were so sharp in the 1980s. But they are far from gone and the behavior of the Japanese government in both bilateral and multilateral settings continues to be problematical. Overall, obstructed access to Japanese markets and the negative behavior of the government continue to be a problem for American trade policy and continues to undermine American support for a global liberal trade and investment regime.

What if anything should the U.S. government do about these continuing problems in the coming decade? There are no easy answers—presidential administrations since the 1960s have grappled with this problem and have tried a variety of approaches, none of which have produced dramatic results. That reality may be the most important lesson: no incoming administration should believe that it can invent a strategy for dealing with Japan that will provide a magic answer to the problem of improving market access. That said, the following suggestions could provide a modest improvement:

First, use the WTO whenever possible, while recognizing its limitations. In the next WTO round, Japan should be pressed hard to make additional concessions (the Japanese government claims to prefer WTO-based negotiations and they should be held accountable for their preference). Cases on existing commitments should be pushed when feasible, although the American loss on the color film case is a sobering lesson in the limitations of the WTO in addressing the often informal relationship between government and the private sector.

Second, beyond the WTO, bilateral negotiations on both structural and sectoral issues must continue. Some of these problems lend themselves to a so-called structural approach—dealing with generic rules rather than the problems of a specific industry or sector. Other important issues do not lend themselves to a generic approach. No amount of progress on “deregulation,” for example would have eliminated the very specific problem faced by Motorola in the cellular telephone transmission equipment market in the spring of 1994 (a problem that was essentially political in nature—involving murky political relationships among the Japanese players--and required specific pressure for Japanese government intervention). That is, no incoming administration should believe

that a “structural” approach is superior to a “sectoral” one; the bilateral negotiating agenda requires both.

Third, in seeking to resolve bilateral it is helpful to seek allies within the Japanese economy, while recognizing that they may not materialize. In moving issues forward in any society, it is helpful to have domestic players who are willing to support—directly or indirectly—American positions. American policy toward Japan has often been criticized for failing to seek domestic allies. Certainly that aspect of policy could be improved. But any incoming administration must also recognize that the potential gains from seeking allies could be limited. Japanese consumers, and competitors to NTT (the Japanese government-owned telecommunications firm) would all benefit from the reduction in inter-connect fees and other telecommunications deregulation measures being pressed by the U.S. government, but despite efforts to cultivate supporters in Japan, this issue has remained stalemated in 2000.

Fourth, public rhetoric should be subdued. As irritating and frustrating as bilateral economic issues with Japan are, they are not sufficiently important to deserve angry rhetoric very often from the White House or at the Cabinet level. It is important for these issues to be on the agenda for bilateral summit meetings, and the President and other high-level officials can and should make strong statements to their counterparts at these private meetings. But those statements are best left at the private level in most circumstances.

Fifth, while the rhetoric should be subdued, pressure should not. The Japanese government approaches trade negotiations with the same relentless determination to fight for every possible advantage as characterized the Soviet Union during Cold War arms

negotiations. The Japanese government understands leverage, and often tests the U.S. government to see how soft an administration will be. Therefore, seeking leverage—something that the Japanese side wants or does not want to lose—to use as bargaining chips in a negotiation is extremely important. This process must include a clear willingness to actually retaliate against Japanese economic interests in the United States upon occasion. Retaliation is best pursued through the WTO. However, that process may not always be appropriate or possible. Therefore, it remains important for any administration to understand and be willing to apply retaliation on a unilateral basis. This is not a tool to be used lightly or often, but is a necessary ingredient in solving some problems and in alerting the Japanese government to American seriousness in trade issues. There is no inherent conflict between the point above about maintaining a lower-profile rhetoric; the old adage “speak softly but carry a large stick” applies. Unilateral retaliation would almost certainly be challenged by Japan at the WTO—but there may be circumstances when that challenge should be recognized as an acceptable cost of this strategy. In 1995, for example, the choice of punitive tariffs on Japanese luxury cars was brilliant (whatever one may think of the merits of the auto negotiations in which the tariffs were threatened as leverage) because Nissan would most likely have gone bankrupt before Japan’s WTO challenge was completed.

Finally, trade negotiations with Japan require increased human resources in the U.S. government. Woefully few people in the government are involved with economic relations with Japan (a problem that goes beyond trade to include the Treasury Department as well). Especially if the government is to pursue an increased caseload of WTO cases (which require a high standard of evidence) and seek closer relations with

potential allies within Japan, increased staffing is critical. Despite the perception of high-profile bilateral trade relations, the reality is that these issues are handled by only a dozen officials in Tokyo, and perhaps two dozen in Washington.

This set of suggestions will not bring about an open market in Japan. But it will keep the process of chipping away at those barriers moving forward. Broader change that makes Japan more open depends on shifts in attitudes among policy elites and the public in Japan. Despite some positive shifts over the past decade (such as being somewhat more welcoming toward inward foreign direct investment), Japan remains a remarkably insular society, both economically and socially. No one should expect dramatic change in that insularity.

Appendix: The Purpose of Japan's Foreign Reserves and Current-Account Surpluses

What has been the motivating factor in the heavy accumulation of Japan's official foreign exchange reserves? That is, have they been accumulated partly for purposes of financing the retirement of the baby boom generation, or are they related mostly to yen exchange rate policy. Somewhat similar questions apply to the meaning or motivation of the continuous build-up of Japan's current-account surpluses. These questions are addressed here.

Official foreign exchange reserves are pretty clearly held as part of foreign exchange policy. Consider first that there is no institutional mechanism by which social security funds would end up in the hands of the Bank of Japan for this purpose. Japan has two pieces to its social security system—a public pension plan for the self employed, and one for employees of corporations. The social security taxes (or contributions, as the Japanese government insists on calling them), for both plans are paid to an agency of the Ministry of Health and Welfare (MHW). Until the 1990s, the MHW then turned over all the receipts to the Ministry of Finance to be invested as part of the Fiscal Investment and Loan Plan (FILP). The FILP provides loans for public policy purposes—such as to the Japan Development Bank, which in turn lends money to electric utilities, steel companies, and other industries. Some of these funds have also been used to purchase government bonds. However, the Bank of Japan is not a recipient of loans from the FILP—the government publishes a complete list of all agencies that borrow from the FILP, and the Bank of Japan is not among them.

A change began in the late 1980s. The Ministry of Health and Welfare lobbied to retain control over some of the social security funds it received, investing them however it saw fit in order to earn a higher rate of return than the one negotiated with the Ministry of Finance. Roughly 13 percent of social security funds are currently under the direct control of the MHW (through a subsidiary organization called the Pension Welfare Service Public Corporation--PWSPC). Lacking its own portfolio management expertise, the PWSPC contracts with a number of investment banks and insurance companies to manage the investment of these funds. Presumably these are invested in a variety of both public and private sector financial instruments, both domestic and foreign—but the Bank of Japan is again outside the framework. In theory, MHW will gain control of all social security funds within two years as the FILP comes to an end in its current format.

Aside from the institutional evidence separating these funds from the Bank of Japan, consider the trend in foreign exchange reserves. The following table provides data on the actual foreign exchange reserves at the end of each calendar year. These data certainly demonstrate a remarkable increase in foreign exchange holdings by the Bank of Japan, particularly since 1985. In just over two years, from the end of 1997 to the end of April 2000, reserves have expanded by over \$100 billion.

What explains this extraordinary increase? The answer lies in foreign exchange policy. The U.S. government has an official policy of having no exchange rate policy; and even though the official position may be a bit of an exaggeration, certainly the U.S. government has very broad bands for exchange rates that must be exceeded before the government begins to comment on the dollar being too strong or too weak, and actual

intervention in foreign exchange markets has been relatively rare. In great contrast, the Japanese government has a rather explicit exchange rate policy, and relatively narrow bands beyond which it begins to comment, cajole financial institutions to alter their foreign exchange trading or their investment strategies for foreign-currency-denominated financial assets, and intervene directly in the market.

Japan Official Foreign Exchange Reserves (in Billions of U.S. Dollars)	
Year	Dollars
1980	25.2
1981	28.4
1982	23.3
1983	24.5
1984	26.3
1985	26.5
1986	42.2
1987	71.5
1988	97.7
1989	84.9
1990	77.1
1991	60.0
1992	68.7
1993	95.6
1994	122.8
1995	182.8
1996	217.9
1997	220.1
1998	215.9
1999	288.1
Apr 2000	338.6

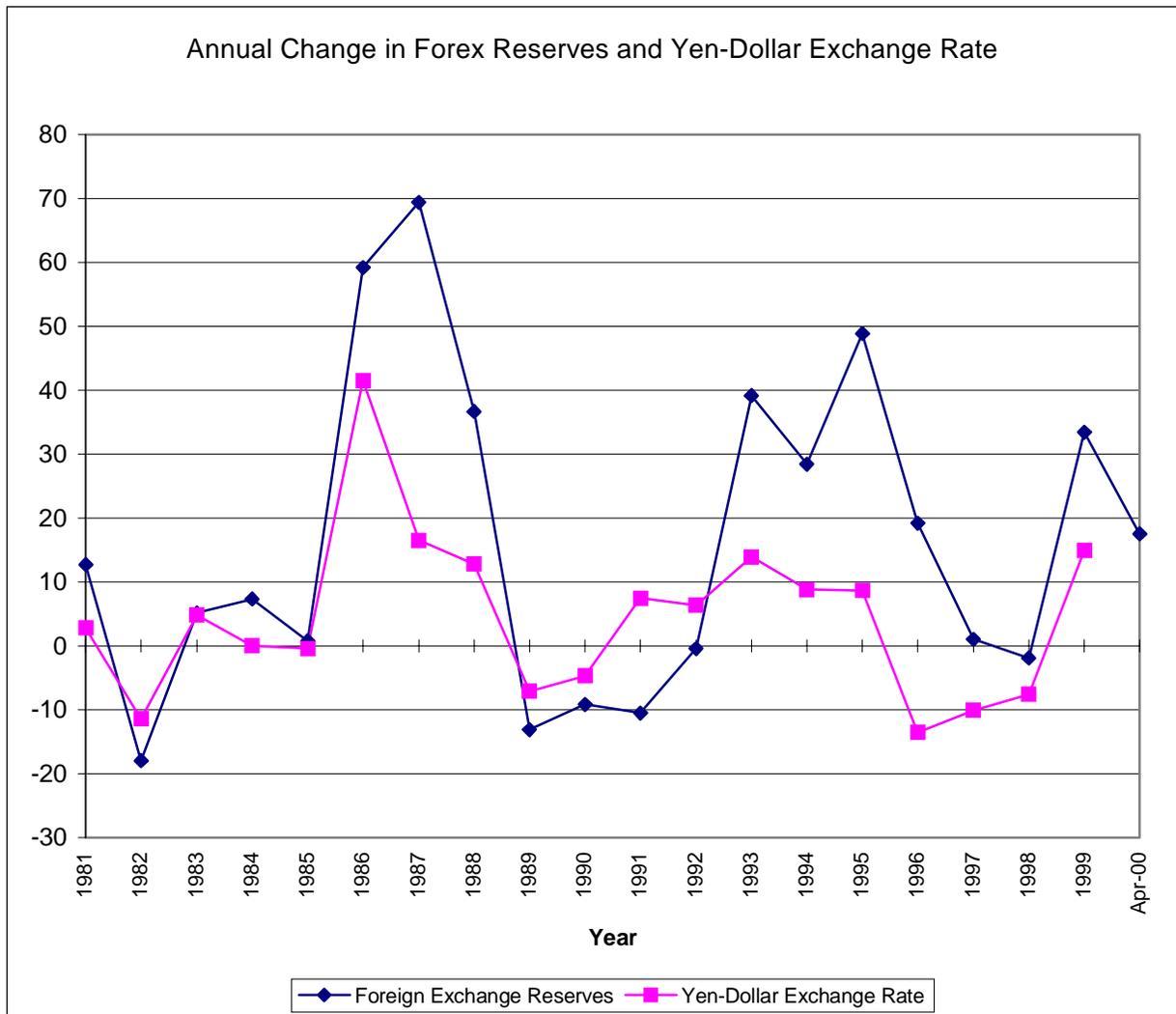
Source: Bank of Japan, *Balance of Payments Monthly*, various issues; and Ministry of Finance, <http://www.mof.go.jp/english/e1c006.htm>.

A guiding principle in this foreign exchange rate policy has been a long-term determination to prevent the yen from appreciating “too much,” or, as others would put it, to maintain a weak yen. A key element of Japan’s postwar economic policy was

promotion of exports. Economists still argue over whether one can characterize postwar growth as “export driven.” But there is no doubt that the government believed that promotion of exports was critical for economic growth—both to generate sufficient foreign exchange earnings to pay for needed imports (in the early postwar years when there were chronic problems of current-account deficits) and because competition in global markets would drive industries to higher levels of productivity. This desire to promote exports has never disappeared from Japanese economic policy goals, despite official rhetoric to the contrary.

Rising current-account surpluses in the late 1960s and beginning of the 1970s under the fixed exchange rate (360 yen per U.S. dollar) of the Bretton Woods System implied that the exchange rate was increasingly out of line. The government was so committed to maintaining the exchange rate, however, that Japanese resistance to yen revaluation in 1971 was one of the major contributing factors in the U.S. government decision to break the convertibility of the dollar into gold. From that time to the present, the Japanese government has continued to express dismay over the concept of floating exchange rates. Officially their concern has been over the negative impact of exchange rate volatility on international business transactions. Many analysts, however, believe that the real motive has been to keep the yen weaker than would be the case in a freely moving foreign exchange market. Two analysts in Tokyo—Akio Mikuni (who runs a bond rating agency in Tokyo) and Taggart Murphy (a former investment banker in Tokyo) are currently working on a book manuscript for the Brookings Institution on the history of this policy.

Whether the government has been successful in this policy goal remains a matter of controversy. With the yen currently trading at 107 yen per dollar, *versus* 360 in 1971, the facts would suggest that the policy has been a failure. My own view is that the policy has failed in the long run but not the short run. In the short run, the policy may succeed for a period of time, but eventually the cost of keeping the yen weak becomes too great (in terms of embarrassingly large increases in foreign exchange reserves).

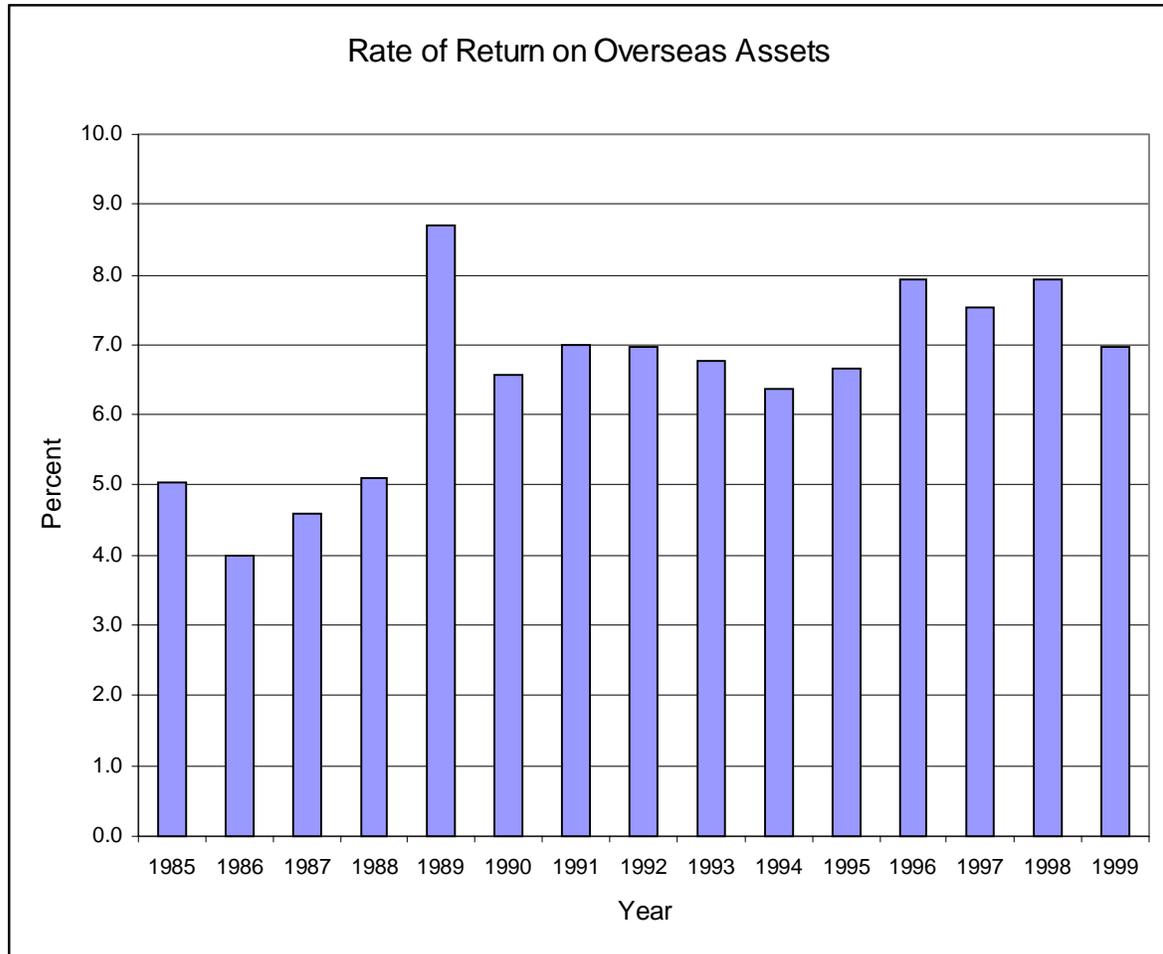


Source: Exchange rates are taken from International Monetary Fund, *International Financial Statistics Yearbook*, 1990, and *IFS CD-ROM*; foreign exchange reserves are taken from Bank of Japan, *Balance of Payments Monthly*, various issues, and Ministry of Finance, <http://www.mof.go.jp/english/e1c006.htm>.

The importance of this motive for foreign exchange reserves is clearly visible in the preceding figure, showing the annual percentage change in the exchange rate (the dollar-yen rate) and size of foreign exchange reserves. The exchange rate data for this figure come from annual average rates, and miss some of the peaks and troughs in the turning points. From late 1994 through April 1995, for example, the yen rose to a peak of only 79 yen per dollar, and the Bank of Japan foreign exchange reserves rose by \$2-4 billion a month as it tried to offset the trend. More recently, reserves have risen very rapidly because the government was worried that renewed yen appreciation would choke off economic recovery by damaging exports. The two series track very closely. When the yen appreciates, the Bank of Japan buys dollars aggressively in an attempt to restrain the trend. When the yen is stable or falling, the Bank uses the lull to draw down its reserves.

Now consider the broader possibility—that private-sector holdings of overseas assets are a necessary part of the coming needs for financing the bulge in retirees. This is a more realistic possibility. With foreign exchange deregulation in the 1970s and early 1980s, movement of capital into and out of Japan was largely decontrolled (a further round of deregulation in 1998 actually had only a minor additional impact). With free flow of capital, acquisition of foreign real and financial assets accelerated. The current-account surpluses since the early 1980s have led to very large net holdings of foreign assets (currently \$1 trillion), and gross assets are much higher (\$2.7 trillion). The following figure provides a very simple assessment of rate of return on those assets—the

ratio of investment earnings reported in the balance of payments to the size of reported assets.



Note: Up to 1994, both overseas assets and investment income in the balance of payments are reported in U.S. dollars; since 1995 both items have been reported in yen.

Source: Bank of Japan, *Balance of Payments Monthly*, April 1994, April 1995, April 1999, and (for 1999 data) <http://www.mof.go.jp/english/houkoku/e1c018d.htm>.

These returns appear to be higher than those within the domestic economy, especially in the 1990s. For the 1980s, ROA for Japanese corporations was roughly 4 percent, declining to 2 percent in the 1990s. Long-term government bond rates are currently just below 2 percent, and even in a period of monetary tightening in 1990 peaked at 7 percent. This would suggest that Japanese investors have managed a modestly higher return on

foreign assets than on domestic assets (despite massive exchange rate losses in the 1985-87 period, and heavy losses on bank loans during the Asian financial crisis in 1997-98). To that extent, acquisition of foreign assets contributes to financing the coming heavy financial needs for retirement by providing a higher rate of return on investments that available domestically. Keep in mind, however, that up until now this has pertained mostly to private pensions, and not social security funds (since only a small share of social security funds have been invested outside the confines of the FILP, as discussed above).

Nevertheless, one can challenge the notion that overseas assets are a necessary aspect of retirement financing. Japan continues to have high savings and investment levels in its domestic economy. One can easily imagine an entirely different scenario in which households save less, the economy invests less, but households see the value of their savings increase more rapidly because of higher rates of return. The Japanese generally see their high savings rate as a beneficial and/or necessary feature of their society—providing the funds to finance economic growth and to finance retirement. But the alternative scenario suggests that savings are too high—the availability of so much savings in an economy with a low potential growth rate (low because the economy is mature and demographics are now shrinking the working-age population) has led to investment in extraordinarily wasteful projects. Excess economic regulation, protectionism, and the “weak yen” foreign exchange rate policy (which helps exporters and protects inefficient domestic producers) have also contributed to wasteful investment (in inefficient agriculture, low productivity construction firms, etc.). In an environment of thorough economic deregulation, lower trade barriers, and an end to foreign exchange

intervention, the Japanese economy could very well produce less but more efficient use of investment funds and a household sector that would feel comfortable saving less. Such an environment could well produce a balance among macroeconomic variables (savings, investment, government fiscal balance, and external current-account balance) that involves a smaller current-account surplus. Thus, current account surpluses and the buildup of net foreign assets is necessary only because of other distortions in the economy.

Endnotes

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- ¹ Edward J. Lincoln, *Troubled Times: U.S.-Japan Trade Relations in the 1990s* (Brookings, 1999).
- ² Organization for Economic Cooperation and Development, *Agricultural Policies in OECD Countries* (Paris: OECD, 1999), pp. 19, 124, 166-68.
- ³ Ministry of Agriculture Food and Fisheries, *FY Annual Report on Food, Agriculture and Rural Areas in Japan in 1999 (Summary)*, <http://www.maff.go.jp/hakusyo/kaigai/ehakusyo99.htm#CHP1-2>.
- ⁴ For a detailed analysis of the situation in Japanese trade through the mid-1980s, see Edward J. Lincoln, *Japan's Unequal Trade* (Brookings, 1990).
- ⁵ For 1999, GDP data taken from the Economic Planning Agency, <http://www.epa.go.jp/2000/g/qe994/gdemenu.html> with the share of GDP originating in manufacturing assumed to be 25 percent; export and import data taken from Management and Coordination Agency, "Japan in Figures," <http://www.stat.go.jp/english/16.htm>, table 47 (Value of Exports, by Principal Commodities) and 48 (Value of Imports, by Principal Commodities).
- ⁶ For a more detailed presentation and analysis of data concerning intra-industry trade, see Lincoln, *Japan's Unequal Trade*, pp. 39-60; and Lincoln, *Troubled Times*, pp. 31-52.
- ⁷ Industrial Policy Bureau, Ministry of International Trade and Industry, *Survey on Foreign and Domestic Price Differentials for Industrial Intermediate Input*, June 6, 1999, <http://www.miti.go.jp/report-e/gIP9907E.htm>.
- ⁸ The American Chamber of Commerce in Japan, *Making Trade Talks Work: An On-the-Ground Analysis of U.S.-Japan Trade Agreements by American Businesses* (Tokyo: The American Chamber of Commerce in Japan, 2000), p. 17-19.
- ⁹ Two seminal works investigating the low level of foreign direct investment in Japan are: Mark Mason, *American Multinationals and Japan: The Political Economy of Japanese Capital Controls 1899-1980* (Harvard University Press, 1992); and Dennis J. Encarnation, *Rivals Beyond Trade: America Versus Japan in Global Competition* (Cornell University Press, 1992), pp. 36-96.
- ¹⁰ The ACCJ reports 1,553 member firms, of which 119 are actually Japanese firms and 19 non-American owned foreign firms. Data from American Chamber of Commerce in Japan web page, as of 1996.
- ¹¹ Japan's share of global GDP is calculated from data in World Bank, *World Development Indicators 1999*, CD-ROM data disk.
- ¹² William J. Zeile, "Foreign Direct Investment in the United States," *Survey of Current Business*, August 1998, pp. 25, 32; and U.S. Department of Commerce, *Statistical Abstract of the United States*, 1999, pp. 549.
- ¹³ David Weinstein, "Foreign Direct Investment and the Keiretsu," p. 6.
- ¹⁴ Department of Commerce, <http://www.bea.doc.gov/bea/di/fdipos-98.htm>; Ministry of Finance, <http://www.mof.go.jp/english/e1c008.htm>; Lincoln, *Troubled Times*, p. p.80. Year 2000 cumulative direct investments in Japan are estimated by adding the 1998-2000 flows to the stock as of 1997 because the Ministry of Finance has stopped publishing a cumulative total.
- ¹⁵ See Dennis Encarnation, *Rivals Beyond Trade: America Versus Japan in Global Competition* (Cornell University Press, 1992), especially pp. 10-15.

¹⁶ U.S. Department of Commerce, *Survey of Current Business*, July 1999, pp. 29-30. Note that these ratios are for nonbank foreign affiliates of American-owned multinationals.

¹⁷ World Bank, *World Development Indicators 1999*, CD-ROM data disk.

¹⁸ Data calculated from Organization for Economic Cooperation and Development, *International Trade by Commodities Statistics, HS Rev. 1 1988-1996* (on CD-ROM).

¹⁹ U.S. Department of Commerce, *Statistical Abstract of the United States 1999*, p. 841.