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Trade Imbalances and Economic Theory: The Case for a U.S.-Japan Trade Deficit

THE U.S. GOVERNMENT and members of the media have exchanged heated rhetoric with Japan regarding the existence and size of the trade deficit between the two countries which, according to the U.S. Department of Commerce, stood at \$42 billion in 1990.¹ The rhetoric on both sides is exemplified by books such as *Trading Places: How We Allow Japan to Take the Lead in the United States* by former U.S. trade negotiator Clyde Prestowitz, Jr. and *Japan is Not to Blame: It's America's Fault* by Osamu Shinomura, a government economist in Japan. Each of these books blames the other country for the large bilateral trade imbalance between the two. This type of rhetoric assumes that the existence of a bilateral trade deficit is *prima facie* evidence that at least one country is an unfair trader.

In addition, these types of books implicitly endorse what is called the "mercantilist" view of trade—that the bigger the trade surplus a country runs (at the expense of trade deficits for other countries), the better off that country

is. This view, however, was discredited long ago because it denies that trade can be mutually beneficial to both countries. Of course, if trade were not mutually beneficial, it would not occur.

Misperceptions about the nature of the trading relationship and the cause of the trade imbalance between the United States and Japan exist on both sides of the Pacific. This article looks at some of the underlying causes of bilateral trade imbalances. The paper first examines this issue theoretically, then focuses specifically on trade between the United States and Japan. The purpose of this article is to determine whether the U.S. trade deficit with Japan is a natural consequence of the composition of trade between the two countries, the result of "unfair" trading practices, or some combination of the two. The paper concludes with a discussion of recent trade talks between the United States and Japan, and some words of caution about interpreting the meaning of the bilateral trade deficit with Japan.

¹This is seen by the increased call from many in Congress, such as Sen. Richard Gephardt of Missouri and Rep. Helen Bentley of Baltimore, for increased protectionist policies. Similarly, Congress recently passed the Omnibus Trade and Competitiveness Act of 1988, which greatly increased

the power of the U.S. trade representative and Congress to bring charges of unfair trade practices against foreign countries.

TRIANGULAR TRADE

In a world in which trade is conducted across many countries, it is extremely unlikely that trade would be balanced between all pairs of countries, especially if there are significant differences in the composition of their imports and exports. As demonstrated below, it is far more likely that a country will import goods from one country and export goods to another. This pattern is called "triangular" trade.

A Simple Example

Suppose there are three islands, A, B and C, each of which produces one product. Island A produces fuel, which is used to keep the people of Island A warm, and as an input in boat production on Island B. Island B produces boats, but needs fuel from Island A to do so. These boats are used for fishing (the residents of Island B eat only fish) or shipping food. Island C produces fruits and vegetables for domestic consumption, and can also sell them to Island A (whose residents are all vegetarians) if it has boats. The residents of Island C also desire boats for recreational purposes.

If, for simplicity, the value of goods exported is the same for each island and equals \$100, then trade can be described by the following table:

Island	Exports (+)			Imports (-)			Balance
	A	B	C	A	B	C	
A	-	100	0	-	0	100	$(100 - 100) = 0$
B	0	-	100	100	-	0	$(100 - 100) = 0$
C	100	0	-	0	100	-	$(100 - 100) = 0$

Although no island in this example runs an overall trade deficit, each island runs bilateral trade imbalances with the other two. As this highly-simplified example suggests, only under improbable circumstances will trade balance between any pair of countries.

One implication of this example is that policies which hinder trade in an attempt to reduce bilateral trade imbalances will generally make both countries worse off. For example, a country with few energy resources will import significant amounts of oil from oil-exporting countries. To run balanced trade with the oil-

exporting countries, the oil-importing country would have to export an equivalent amount of products (in terms of value) to the oil-exporting countries. If, however, the oil-exporting countries prefer products produced by other countries, the oil-importing country can eliminate its bilateral trade deficits only by importing less oil, which could have negative repercussions on both economies.

The Composition of U.S.-Japan Trade

Japan has few natural resources, and consequently, as table 1 shows, relies heavily on imports of oil and raw materials. To pay for these imports, Japan primarily exports finished manufactured products to industrialized countries, with the United States receiving the largest proportion of these exports.

The composition of U.S. trade differs considerably from that of Japan because the United States primarily imports and exports finished products. In fact, in 1988 (the last year for which complete data is available), approximately 80 percent of U.S. trade (both imports and exports) was in manufactured goods. This difference in the composition of trade (seen in figure 1) for the two countries is reflected in the bilateral trade balances between the countries.

Table 2 shows bilateral merchandise trade balances for the United States and Japan vis-a-vis each other and other groups of countries for selected years between 1965-1989. While there has been a substantial increase in the overall U.S. trade deficit since 1975 (with some improvement in recent years), the United States generally runs a surplus (or smaller deficit) with the western European countries (who import a significant amount of manufactured products) and a deficit against Japan and the developing countries. This pattern existed even before 1976, when the U.S. merchandise trade balance turned negative. For example, although the United States had a \$2.2 billion trade surplus overall in 1975, its bilateral trade balance with Japan was a \$2.8 billion deficit.

Japan, on the other hand, generally runs a trade deficit against the oil-exporting countries and Canada (which exports raw materials and food to Japan) and a surplus against the United States; this surplus occurred even in 1980, when

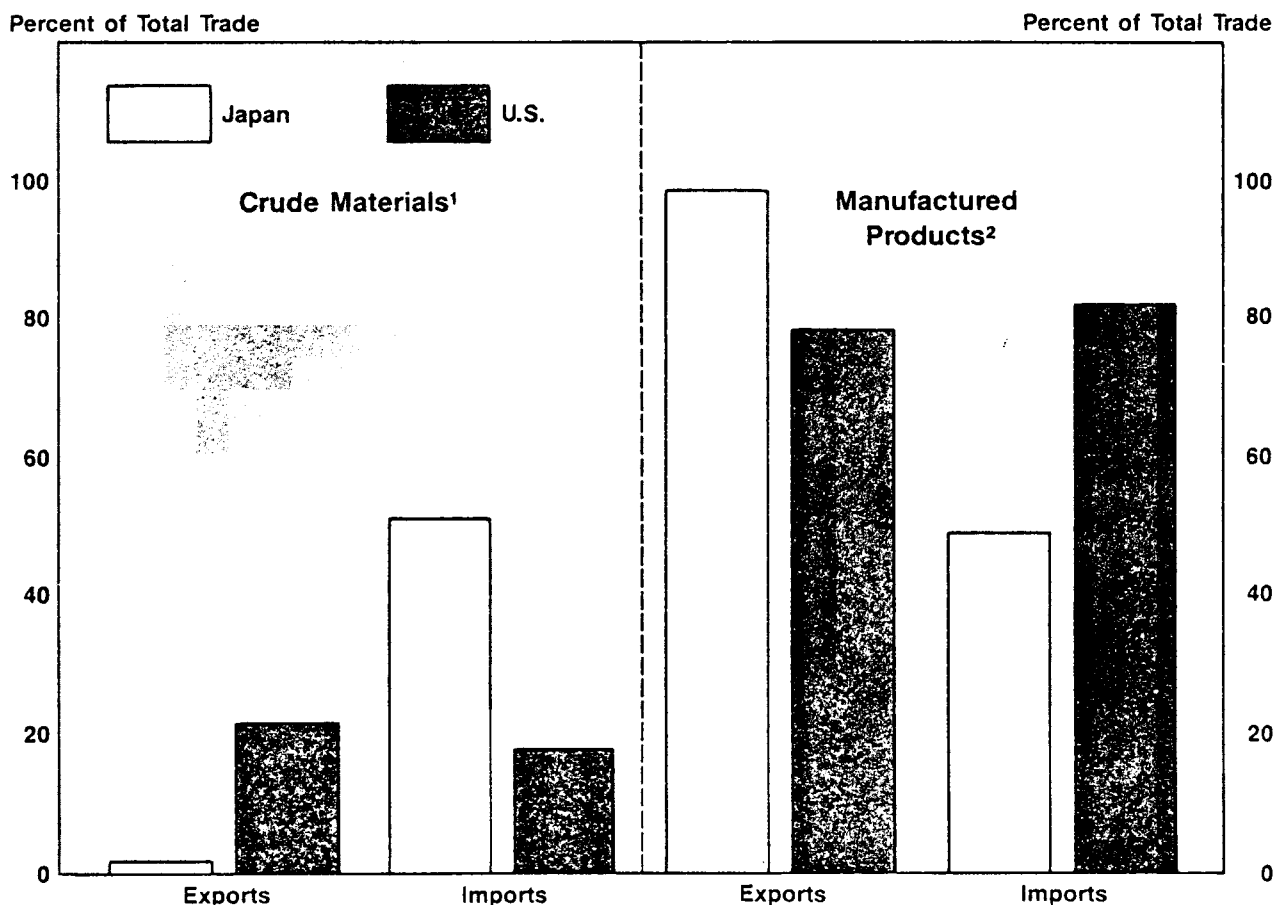
Table 1
Trade by Commodity (as percent of total)

Japan										
Date	Food, beverages, tobacco		Crude materials excluding petroleum		Mineral fuels		Machinery and transport equipment		Other manufactured goods	
	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports
1964	17.5%	4.8%	39.0%	3.2%	17.7%	0.4%	10.4%	29.3%	15.4%	62.3%
1970	13.6	3.4	35.4	1.8	20.7	0.2	11.3	40.5	19.0	54.0
1975	15.2	1.4	20.1	1.6	44.3	0.4	6.6	49.2	13.7	47.5
1980	10.5	1.2	17.0	1.2	50.0	0.4	6.3	54.9	16.2	42.3
1985	12.1	0.7	14.2	0.8	43.8	0.3	8.7	61.7	21.2	36.4
1986	16.0	0.7	14.8	0.7	30.9	0.3	11.1	63.8	27.2	34.5
1987	15.2	0.7	15.2	0.7	26.8	0.3	11.8	65.3	31.0	33.0
1988	15.5	0.6	15.0	0.7	20.6	0.2	13.2	69.4	35.8	29.0

United States										
Date	Food, beverages, tobacco		Crude materials excluding petroleum		Mineral fuels		Machinery and transport equipment		Other manufactured goods	
	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports
1964	21.4%	17.4%	15.9%	13.0%	10.7%	3.5%	11.8%	35.8%	40.1%	30.3%
1970	15.6	11.9	8.7	12.0	7.7	3.7	28.0	42.0	40.1	30.4
1975	10.2	15.8	6.2	10.1	27.2	4.2	25.0	43.1	31.3	26.8
1980	8.0	14.2	4.4	11.8	32.8	3.7	25.0	40.3	29.8	30.0
1985	6.8	10.7	3.1	8.8	15.5	4.9	37.8	47.6	36.7	28.1
1986	7.0	9.8	3.0	8.8	10.4	4.0	41.8	48.3	37.9	29.1
1987	6.3	9.3	3.0	8.6	11.1	3.2	42.1	46.8	37.6	32.1
1988	5.5	10.1	3.1	8.7	9.3	2.7	43.7	46.1	38.4	32.4

SOURCE: OECD Economic Outlook: Historical Statistics. OECD Economic Surveys: Japan (1990).

Figure 1
United States and Japan's Trade by Commodity
for 1988



SOURCE: OECD Economic Outlook: Historical Statistics

¹This includes food, beverages, tobacco, crude materials and mineral fuels.

²This includes machinery, transport equipment and other manufactured goods.

Japan's overall trade balance was in deficit.² Thus, Japan must run a surplus against other countries to pay for its trade deficit with (primarily) oil-producing countries *even if it were to reduce its trade surplus to zero*. As a result, it appears unlikely that U.S.-Japan trade will ever balance. According to one study, triangular

trade patterns alone predetermine a U.S. bilateral deficit with Japan of approximately \$11 billion annually.³

Recent U.S. bilateral trade deficits with Japan, however, have substantially exceeded \$11 billion. The U.S. deficit with Japan reached a high

²The Japanese trade deficit during those years was primarily a result of the oil shock of the 1970s, hence the substantial increase in its trade deficit with oil-producing countries.

³Bergsten and Cline (1985, 1987). When exchange rate effects are included, this estimate becomes larger.

Table 2

Merchandise Trade Balances: Japan and the United States (in billions of dollars)**Japan's Trade Balance With**

Date	United States ¹	Oil-exporting developing countries	Non-oil-exporting developing countries	Canada	Western ² Europe	Overall trade ³ balance
1965	\$ 0.16	\$ -0.67	\$ 0.52	\$ -0.14	\$ 0.10	\$ 0.40
1970	0.46	-1.86	1.45	-0.37	-0.04	0.44
1975	-0.37	-11.60	5.65	-1.35	1.24	-2.12
1980	7.34	-39.64	13.77	-2.30	7.34	-10.85
1985	40.58	-25.97	19.11	-0.24	10.78	46.67
1986	52.52	-13.78	24.76	0.63	17.32	83.06
1987	53.06	-16.74	24.09	-0.45	20.05	80.43
1988	47.98	-16.84	26.64	-1.87	21.24	77.48
1989	45.70	-22.16	26.18	-1.83	17.16	64.96

United States' Trade Balance With

Date	Japan ¹	Oil-exporting developing countries	Non-oil exporting developing countries	Canada	Western ² Europe	Overall trade ³ balance
1965	\$ -0.53	\$ -0.39	\$ 1.89	\$ 0.40	\$ 2.85	\$ 4.48
1970	-1.60	0.11	2.26	-2.70	2.49	0.54
1975	-2.78	-9.50	6.03	-1.01	7.86	2.15
1980	-12.18	-40.19	1.00	-6.60	19.04	-36.18
1985	-49.75	-9.66	-43.27	-22.18	-25.99	-148.47
1986	-58.58	-9.36	-48.72	-23.33	-30.54	-169.78
1987	-59.83	-13.64	-58.03	-11.70	-29.05	-171.18
1988	-55.51	-10.29	-49.80	-11.75	-15.47	-140.36
1989	-52.53	-18.28	-49.27	-11.28	-2.07	-129.52

¹The U.S.-Japan and Japan-U.S. trade balances do not sum to zero because import values include cost, insurance and freight (cif), while export values only include free on board (fob) costs.

²Includes Australia and New Zealand.

³The first five columns do not sum to the total trade balance because the Soviet Union and (former) eastern-bloc countries are excluded due to the unreliability of the data.

SOURCE: International Monetary Fund, Direction of Trade.

of \$57 billion in 1987, and currently (in 1990) stands at \$42 billion.⁴ To explain deficits of this magnitude, other factors besides triangular trade patterns must be examined.

OTHER ECONOMIC FACTORS THAT AFFECT THE TRADE BALANCE

Several other factors play a role in determining the magnitude of the trade deficit with Japan. These factors are both macroeconomic (such as the different savings and investment rates) and microeconomic (such as industry structure and barriers to trade).⁵

Macroeconomic Factors

A nation's savings and investment behavior has a significant effect on its trade balance. The balance on goods described in the previous section is called the merchandise trade balance; it is the most commonly cited trade balance statistic. The current account, the most general measure of a country's trade balance, includes trade in services and earnings on foreign investment both in the United States and abroad (see shaded insert on next page).⁶

The macroeconomic determinants of the current account can be generated from national income accounting identities. The gross national product (GNP) of a country is defined as the following:

$$(1) \text{ GNP} = C + I + G + X - M,$$

where C is private domestic consumption, I is private domestic investment, G is government spending, X is exports, and M is imports. This can be rewritten as:⁷

$$(2) \text{ CA} = (S - I) + (T - G),$$

where CA is the balance on the current account, T is tax revenue and S is private domestic savings.⁸ Thus, any surplus (deficit) in the current account must be due to an excess (shortfall) of net domestic savings, either private, as shown by (S-I), and/or public savings, as given by (T-G).

Table 3 presents the current account balance for the United States and Japan for selected years between 1965 and 1988, along with estimates of net domestic savings and investment rates as a percentage of their respective gross domestic products (GDP).⁹ Any shortfall in net savings must be made up by importing foreign savings; this relationship is measured in the current account. If a country has a negative current account balance, such as the United States, it is a net debtor (that is, it owes more to the rest of the world than it is owed).

As is seen in table 3, the savings/investment differential is almost identical to the balance on the current account.¹⁰ If the savings/investment (or current account) balance is negative, as it has been for the United States since 1982, then that country is a net debtor, which simply means that it spends more on government expenditures and private investment than it saves. This indicates that U.S. citizens have chosen higher levels of consumption now at the ex-

⁴These numbers are from the U.S. Department of Commerce, which uses the same classification for both imports and exports, and thus is a more consistent series. These numbers are not used in the table, however, because a similar measure of the trade balance for Japan is not available.

⁵Another important macroeconomic factor is the behavior of the dollar/yen exchange rate. However, the nature of the relationship between exchange rates and the trade balance is the source of a vast literature. The exact link between these variables remains unresolved. Even studies that argue that the exchange rate has been a substantial factor in the trade imbalance between the United States and Japan remain unable to completely explain the size of the trade deficit. For simplicity, therefore, the relationship between the dollar/yen exchange rate and the U.S.-Japan trade balance is ignored here. For discussions of this relationship, see, for example, Haynes, Hutchison and Mikesell (1986), Bergsten and Cline (1985, 1987) and Sakamoto (1988).

⁶While the magnitude of the merchandise trade and current accounts are not identical, they have moved fairly closely

together over time. Although the current account is the more general measure of trading activity, bilateral current account figures are not available. For a more detailed discussion of the balance of payments statistics, see U.S. Department of Commerce (1990).

⁷For a derivation of Equation 2, see Chrystal and Wood (1988).

⁸For details and a more complete discussion of national income accounting in an open economy, see Dornbusch (1980).

⁹The difference between GNP and GDP is that GDP excludes net factor payments from abroad while GNP includes them.

¹⁰In fact, the only difference is due to measurement error, because the current account is measured in terms of goods, services and income flows rather than in terms of savings and investment. The difference is analogous to the statistical discrepancy between the expenditure and income approaches to calculating GNP.

Different Measures of the Trade Balance

The merchandise trade balance measures the difference between the value of imported and exported goods. The merchandise trade figures do not account for other forms of trade such as trade in services and investment. These are included in the current account, which is the more general measure of the trade balance. In 1989, merchandise trade accounted for

73.4 percent (\$360 billion) of total U.S. exports (\$491 billion), and 85.7 percent (\$493 billion) of total U.S. imports (\$575 billion). As trade in services and foreign direct investment increases internationally, the distinction between the two measures of the trade balance becomes more important. The difference can be seen in the following summaries:

Credits to the current account

- Exports of goods such as food and computers produced in the United States.
- Exports of services such as banking and insurance sold to foreigners by U.S. companies.
- Receipts of income on U.S. assets abroad such as repatriated earnings of a Ford assembly plant in Mexico.

Debits to the current account

- Imports of goods such as cars produced in Japan.
- Imports of services such as a U.S. citizen holding a Swiss bank account in Switzerland.
- Payments of income on foreign assets in the United States such as profits earned by a Japanese auto plant in Ohio.
- Unilateral transfers such as U.S. government transfer payments abroad.

Balance on Merchandise Trade = Exports of Goods - Imports of Goods.

Balance on the Current Account = Credits - Debits.

1989 Current Account Balance For The United States (millions of dollars)

Exports of goods, services and income	\$603,169
Merchandise, excluding military	360,465
Services	115,169
Income receipts in investment	127,536
Imports of goods, services and income	\$698,483
Merchandise, excluding military	475,329
Services	94,706
Income payments on investments	128,448
Unilateral transfers	-\$ 14,720
Balance on merchandise trade	-\$114,864
Balance on current account	-\$110,034

Table 3
Savings, Investment and the Current Account (as percent of GDP)

Japan				
Date	Investment	Savings	Savings-Investment	Current Account
1965	31.94%	33.34%	1.40%	1.01%
1970	39.02	40.30	1.28	0.98
1975	32.77	32.81	0.04	-0.14
1980	32.24	31.35	-0.90	-1.01
1985	28.52	31.93	3.41	3.71
1986	28.12	32.15	4.03	4.38
1987	29.15	32.36	3.21	3.67
1988	30.96	33.26	2.31	2.80

United States				
Date	Investment	Savings	Savings-Investment	Current Account
1965	20.16%	20.74%	0.57%	0.77%
1970	17.91	18.04	0.13	0.23
1975	16.96	17.81	0.85	1.14
1980	18.94	18.36	-0.58	0.07
1985	18.68	15.69	-2.99	-3.07
1986	18.25	14.94	-3.31	-3.46
1987	18.04	14.65	-3.39	-3.60
1988	17.43	15.22	-2.21	-2.66

SOURCE: International Monetary Fund, International Financial Statistics.

pense of lower consumption later, instead of saving more now and consuming more later.¹¹

How does this affect U.S. trade with Japan? Japan has a positive (and, until recently, an increasing) savings/investment balance.¹² This means its citizens have chosen to attain higher levels of consumption in the future relative to higher current consumption. As a result, Japan's net savings are invested abroad, with much of its savings flowing into the United States. Indeed, the United States has been a good place for foreign citizens to invest their savings for several reasons; until recently, the United States

has had relatively higher interest rates than many industrial countries, and it is a safe haven for foreign investments since there is essentially no possibility that the United States government will default on its bonds.

As a result, the fundamental difference in their net savings positions is a significant factor in the size of the U.S.-Japan bilateral trade deficit.

Microeconomic Factors

Microeconomic factors also affect the volume of imports and exports and therefore the trade

¹¹There is much debate over whether the size of the U.S. current account deficit is undesirable. For some arguments as to why a current account deficit might have a positive effect on an economy, see Chrystal and Wood (1988).

¹²The "high" rate of savings in Japan is usually attributed to many different factors, including the price of housing, the demographics of the population and the tax system.

For a discussion of the savings and investment rates and their implications for Japan's economy, see Bergsten and Cline (1985, 1987) and Belassa and Noland (1988). For a discussion of some problems in measuring the savings rates in the two countries, see Christiano (1989) and Hayashi (1989).

balance of a country. It is often argued that Japan has implicit and explicit trade barriers and that its economy inherently has a more protectionist *structure* than economies in other industrialized countries.

There have been several attempts to measure empirically how "open" the Japanese economy is to imports. Such estimates vary widely due to different assumptions and methodologies. In general, however, these studies usually find little evidence that the composition of Japan's exports and imports deviates substantially from what general economic trade theory would predict, given Japan's comparative advantage and location.¹³ Nevertheless, the perception that Japan is more protectionist than other industrialized countries still remains. As a result, there have been several bilateral negotiations between the United States and Japan such as the Market-Oriented Selected Sector (MOSS) talks in the mid-1980s directed at increasing trade in specific sectors.¹⁴ There is some evidence that these talks have had some success. In the past four years, U.S. firms have increased their annual sales in semiconductors by nearly \$1 billion (roughly a 4 percentage point increase).¹⁵ More recently, such talks have expanded to include more general policies that affect trade, as seen in the recently-concluded Structural Impediments Initiative (SII). These talks were an attempt to "identify and solve structural problems in both countries that stand as impediments to adjustments in trade and balance of payments accounts, with the goal of contributing to a reduction of trade imbalances."¹⁶ The SII is discussed in more detail below.

Explicit Trade Barriers — In terms of its explicit trade barriers, Japan's tariffs and subsidies are fairly low. Figure 2 shows the change in tariffs before and after the Tokyo Round of negotiations of the General Agreement of Trade and Tariffs (GATT), the last completed round

of multilateral trade negotiations, which demonstrates that Japan has reduced these barriers by more than the European Community. In fact, Japanese tariff rates on industrial goods are, on average, lower than U.S. rates. Overall, most studies agree that Japan's explicit trade barriers are not out of line with other industrialized countries.

There are certain sectors, however, that remain heavily protected in Japan. The most extreme example is rice, which cannot be imported by Japanese law. Japanese officials argue that this ban is necessary for national security, because of Japan's dependence on foreign sources for much of its food stuffs. U.S. industry officials, on the other hand, argue that if the ban were lifted, U.S. rice exports could rise to as much as \$656 million.¹⁷

Typically agriculture is heavily subsidized in industrialized countries; the U.S. rice industry is no exception. As of 1986, the U.S. rice industry was the most heavily subsidized U.S. grain.¹⁸ As a result, if current negotiations succeed in opening Japan's rice market to foreigners, U.S. rice subsidies will have a distorting effect on trade. Studies that attempt to measure the effect of eliminating this trade barrier with Japan must take into account the price distortions resulting from subsidies in other countries as well.

Implicit Trade Barriers — A more contentious issue between these countries, however, involves implicit trade barriers, which are less clearly defined and therefore their effect is more difficult to measure. Such barriers can take various forms. Table 4 provides a description of selected trade barriers, most of which Japan has been accused of employing. The first section lists explicit trade barriers, while the lower half of the table lists implicit barriers. For example, standards, testing and certification procedures can be used as trade barriers if the regulations discriminate against foreign firms.

¹³See, for example, Saxonhouse and Stern (1989), Bergsten and Cline (1985, 1987) and Belassa and Noland (1988). For a critical discussion of these studies, see Cline (1990). For a dissenting view, see Lawrence (1987).

¹⁴These talks focused on four areas: telecommunications, electronics, forest products and medical equipment and pharmaceuticals. These sectors (excluding forest products) are imperfectly competitive, which creates the possibility that profits are earned above economic costs (including the cost of capital). Recent trade theory has suggested that government can, through trade barriers, shift these profits from foreign to domestic firms. This policy is called

"strategic trade policy," (although the term strategic refers to the government actions, not national security). The practical problems of trying to use this policy, however, appear to override its theoretical justification. For further discussion, see Krugman (1987) and Coughlin and Wood (1989).

¹⁵Schlesinger (1990)

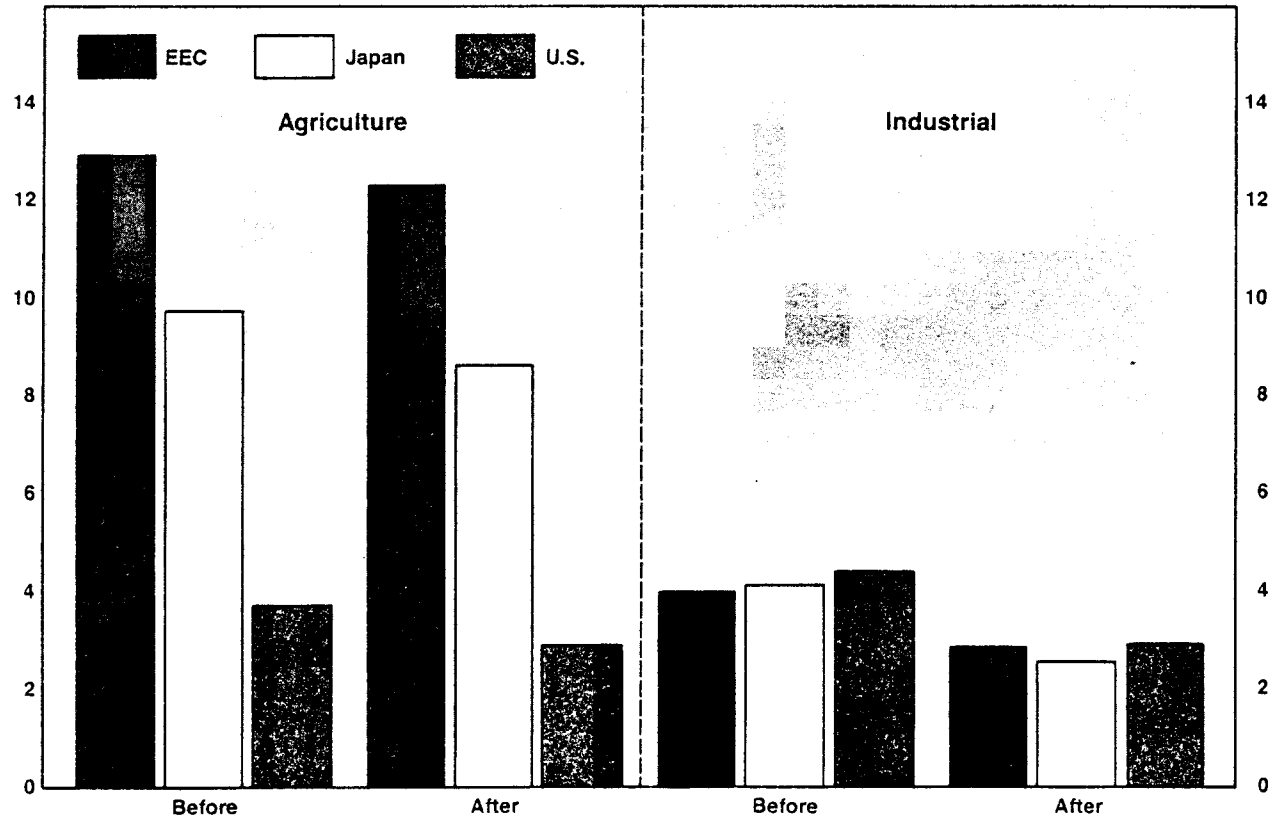
¹⁶Assistant trade secretary Charles Dallara in Rowen (1990).

¹⁷Office of the U.S. Trade Representative (1990).

¹⁸This is determined using producer subsidy equivalents. For more detail, see Webb, Lopez and Penn (1990).

Figure 2 Rate of Average Tariffs

Before and After the Tokyo Round



SOURCE: OECD Economic Surveys: Japan

One example of this type of discriminatory practice—taken from a recent book by former U.S. trade negotiator Clyde Prestowitz, Jr.—occurred when U.S. firms attempted to sell baseball bats in Japan.¹⁹ After a U.S. company finally received approval to sell aluminum bats in Japan, new standards for the required safety seal from the government were introduced that necessitated the use of a specific aluminum alloy as well as a base plug not found in U.S.-produced bats.

After the U.S. filed a formal complaint through procedures established by GATT, the standards were revised to allow U.S. firms access to the Japanese aluminum baseball bat market. New

restrictions, however, were then passed, requiring inspection of the factory and products to take place in Japan. Because the bats were produced in the United States, Japanese officials individually inspected every lot of bats upon arrival in Japan. This slowed down imports and increased the cost of importing bats, making them less competitive. While this issue has since been resolved and the restrictive requirements have been eliminated, it provides a good example of how implicit trade barriers are used.²⁰

Another example of implicit trade law restrictions is seen in the Japanese Large Scale Retail Store Law, which was recently modified as a re-

¹⁹See Prestowitz, Jr.(1988).

²⁰For further discussion and analysis of implicit trade barriers in Japan, see Christelow (1985-86), Cline (1990) and Belassa and Noland (1988).

Table 4

Selected Non-Tariff Trade Barriers

Explicit Trade Barriers

- | | |
|---|---|
| 1. Import quotas | Restrictions on quantity and/or value of imports of specific commodities for a given time period; administered globally, selectively or bilaterally. |
| 2. Voluntary export restraints | Restrictions imposed by importing country but administered by exporting country; administered multilaterally and bilaterally; requires system of licensing; essentially similar to an orderly marketing arrangement. |
| 3. Domestic content and mixing requirements | Requires that an industry use a certain proportion of domestically produced components and/or materials in producing final products. |
| 4. Antidumping duties | Imposition of a special import duty when the price of imports is alleged to lie below some measure of foreign costs of production; minimum prices may be established to "trigger" antidumping investigations and actions. |
| 5. Countervailing duties | Imposition of a special import duty to counteract an alleged foreign government subsidy to exports; normally required that domestic injury be shown. |

Implicit Trade Barriers

- | | |
|---|---|
| 1. Government procurement policies | Preferences given to domestic over foreign firms in bidding on public-procurement contracts, including informal procedures favouring procurement from domestic firms. |
| 2. Macroeconomic policies | Monetary/fiscal, balance-of-payments, and exchange-rate actions which have an impact on national output, foreign trade and capital movements. |
| 3. Competition policies | Antitrust and related policies designed to foster or restrict competition and which may have an impact on foreign trade and investment. |
| 4. Government industrial policy and regional development measure | Government actions designed to aid particular firms, industry sectors, and regions to adjust to changes in market conditions. |
| 5. Government financed research and development and other technology policies | Government actions designed to correct market distortions and aid private firms; includes technological spillovers from government programmes, such as defense and public health. |
| 6. Health and sanitary regulations and quality standards | Actions designed for domestic objectives but which may discriminate against imports. |
| 7. Safety and industrial standards and regulations | Actions designed for domestic objectives but which may discriminate against imports. |

SOURCE: Deardorff and Stern, 1985.

sult of the SII talks. This law required neighborhood approval in Japan for any store larger than 5400 square feet. Neighborhood shop owners were able to effectively block large retailers from opening stores that could charge lower prices because of their economies of scale (for example, because of the volume of each product bought by Toys "R" Us, it can charge lower prices than a small neighborhood toy store that purchases only a few of each product).

This policy blocked foreign firms, such as Toys "R" Us, from opening stores in Japan. Some firms in the United States also argued that limiting the size of each shop reduced the likelihood of U.S. products being sold. Many Japanese, on the other hand, argued that these laws serve to protect a way of life in Japan. Although changes in the retail store law that weaken the power of neighborhood shop owners may increase U.S. access to these markets, it may also, in the eyes of some Japanese, have adverse social consequences by altering the structure of neighborhoods.²¹ This conflict between domestic and trade policy goals underlies much of the problems that arise in negotiating trade disputes between Japan and the United States.

IMPLICIT TRADE BARRIERS: TRADE POLICY OR DOMESTIC POLICY?

One difficulty in determining the intent of economic policies is the problem of separating domestic and trade-related policies, such as in the retail law described above. Another example of this problem can be seen in the different anti-trust legislation in the United States and Japan. While it is illegal in the United States for a company to require a distributor to sell only the company's line of products, this practice is permitted under certain conditions in Japan.²² As a result, many U.S. manufacturers have had difficulty finding distributors for their

products because the existing distribution system is controlled by companies already in the market. While U.S. policymakers have considered this an unfair trade practice, new Japanese firms trying to enter these same markets encounter the same difficulty. Thus, referring to these regulations as "unfair" trade practices may be incorrect, because the policy treats both foreign and domestic firms exactly the same. Indeed, at the heart of this problem is the debate between the notion of *reciprocity*, the idea that firms must be given the same opportunities in a foreign country that foreign firms would have in the domestic market, and the notion of *national treatment*, which argues that foreign firms should be treated the same as a nation's domestic firms.²³

Another example of the problem of distinguishing between domestic and trade policies is the relationship between suppliers and purchasers. Companies in Japan typically have long-term implicit (and sometimes explicit) contracts with their suppliers. While it has frequently been alleged that these arrangements are intended to exclude foreign firms, they actually serve several useful economic purposes unrelated to foreign trade. For example, because Japanese land prices are higher than those in the United States, it is relatively more costly for firms to hold inventories in Japan. As a result, firms arrange for more frequent purchases of inputs (referred to as "just in time" scheduling) rather than maintaining sizable inventories of raw materials. Long-term arrangements with suppliers provide one way to economize on the costs of frequent recontracting. Other Japanese policies that are sources of trade disputes between the United States and Japan include the procedures for obtaining patents, government-supported research and development and public expenditure on infrastructure (such as roads and sewers).²⁴

Criticism of domestic practices affecting the flow of trade has also been leveled against the United States. For example, the U.S. government

²¹See, for example, Sanger (1990).

²²Under the Antimonopoly Act, restricting the business transactions between the firm's trading partners and competitors is, in general, illegal if such conduct could result in limiting the options of the firm's competitors. Whether the business opportunities of the competitor have been reduced is to be decided on a case-by-case basis, and there are many exceptions to these regulations.

²³This article assumes that national treatment is the appropriate policy. For a recent discussion of this issue, see Bhagwati and Irwin (1987).

²⁴These policies are described in greater detail in Belassa and Noland (1988).

Structural Impediments Initiative

The Structural Impediments Initiative (SII) was an unusual trade agreement for several reasons. In particular, the negotiations focused primarily on domestic policies with implications for the trade deficit between the United States and Japan. As a result, negotiators were in the unusual position of demanding changes that could benefit the foreign country as well as the negotiators' own country. For example, the U.S. wanted the Japanese to "reform" its distribution system. In doing so, Japan might not only increase U.S. firms' access to these markets, but also improve their own market efficiency.¹

These talks were also unusual in that they addressed broader, more fundamental macroeconomic factors rather than focusing on problems in specific sectors as in previous talks. One problem with specific sector negotiations is that agreements and their subsequent enforcement do not necessarily imply a reduction in the bilateral trade deficit. As discussed by Frankel (1990), this "results-oriented" approach has the unfortunate consequence that failures to reduce the trade

deficit are seen as "proof" that the agreements are not being honored.

One problem with SII is that much of the "agreement" is not binding, particularly on the United States. Rather, the language is couched in terms of commitments to improving these areas and not in terms of formal obligations. Although many analysts believe these talks will have little, if any, effect on U.S.-Japan trade, there is some preliminary evidence that both countries are at least attempting to implement some of these changes. The U.S. Congress has passed a new budget-reduction plan; moreover, Japan's budget calls for an increase in spending on public infrastructure.²

Summary of the SII agreement

Among other things, Japan agreed to the following:³

1. Expanding investment in social overhead capital (e.g., water supply, sewers, housing, parks), transportation infrastructure, international ports and airports and cargo and customs processing facilities.

¹This twist in trade negotiations is discussed in an aptly titled paper, "The Structural Impediments Initiative: Japan Again Agrees to Become More Efficient," by Jeffrey A. Frankel (1990).

²For a discussion of attitudes regarding the SII, see U.S. International Trade Commission (1990).

³These summaries are taken from the Joint Report of the U.S.-Japan Working Group on the Structural Impediments Initiative (1990).

budget deficit has been blamed for much of the U.S. trade deficit, because it contributed to the demand for foreign savings. As a result, the size of the federal deficit has been an issue in recent negotiations to reduce the U.S. bilateral trade deficit with Japan. Thus, issues that once were considered purely domestic now begin to enter trade negotiations. The most recent example of this phenomenon is the Structural Impediments Initiative (see shaded insert above).

Whether that initiative will be successful in reducing the U.S.-Japan trade deficit is unclear. Perhaps the biggest problem is that there are few obligations for either country to implement specific policies. Not surprisingly, as a result of these talks there has been considerable debate over the usefulness of this type of bilateral trade negotiation.²⁵ Recent evidence, particularly in Japan, suggest that these talks have had some effect. Aside from the changes to the Large-

²⁵For a discussion on how to measure the effectiveness of these types of policy declarations, see von Fürstenberg and Daniels (1990).

2. Reviewing its land policies, including taxes, use restrictions and zoning laws to more fully utilize public lands.
3. Reviewing standards, testing and certification requirements, introducing greater transparency in the issuance of official administrative guidance and in the operations of industry advisory committees and government study groups.
4. Improving import procedures and relaxing laws and regulations that impede foreign direct investment and restrict entry by large retailers, liquor stores, truck operators and pharmacies.
5. Examining and revising as necessary the Japan Fair Trade Commission and other government policies toward premium offers, advertisements and vertical business practices affecting consumer goods (e.g., resale price maintenance, "suggested prices," exclusive dealerships or territories, rebates and returns).

The United States also made a series of concessions; however, these appear to be less

binding and generally emphasize "intention" rather than "commitment." Among other things, the United States agreed to the following:⁴

1. Reaffirming its goals to reduce the size of the budget deficit.
2. Encouraging private savings and reducing consumer debt by tightening access to credit cards.
3. Reducing the cost of capital for corporations through such mechanisms as a lower capital gains tax.
4. Reducing U.S. export controls and liberalizing import restrictions such as the voluntary export restraint agreements on steel and machine tools.
5. Increasing funds for research and development and spending on education (in particular, for foreign language, mathematics and science).
6. Maintaining non-discriminatory treatment of Japanese investment in the United States.

⁴These summaries are taken from the Joint Report of the U.S.-Japan Working Group on the Structural Impediments Initiative(1990).

Scale Retail Store Law already discussed, the current Japanese budget calls for a 6.2 percent increase in spending on public works (such as roads and housing).²⁶ In fact, some analysts have suggested that these negotiations actually provide a rationale for countries to implement unpopular domestic reform.²⁷ For example, although regulations limiting the size of retail stores are very popular, one effect of this law is that consumers pay higher retail prices. For this reason, there has been pressure (both inside and outside Japan) to open these markets; the SII included an agreement to relax these regulations. In the United States, the agreement to maintain non-discriminatory treatment of Japanese investment in the United States comes

at a time when there is increasing concern voiced in the media regarding recent Japanese purchases in the United States of such high profile items as Rockefeller Center in New York City and Columbia Pictures in Hollywood.²⁸ A new round of talks on structural impediments began January 17, 1991.

A more serious problem with bilateral trade agreements is that the issues they attempt to address are inherently multilateral rather than bilateral. In general, a reduction in Japan's trade restrictions affects its trade with not only the United States but virtually all other countries as well. For this reason, there has historically been more support, particularly in the United States, for multilateral negotiations.

²⁶Thompson (1990). See also "You Won't Know it in 2000" (1991).

²⁷See, for example, Frankel (1990).

²⁸See, for example, Smith (1990). For a discussion of foreign investment in the United States and some of the common misperceptions, see Tolchin and Tolchin (1988).