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DOCUMENT NO. & TYPE	SUBJECT/TITLE	DATE	RESTRICTION
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1. Cable	261221Z JAN 81, 2p <i>R 7/24/06 F00-037/1 #7</i>	1/26/81	B1
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RESTRICTIONS

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DATE 02/03/81

WHITE HOUSE SITUATION ROOM

PAGE 001

WHSR COMMENT:

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MESSAGE ANNOTATIONS:

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MESSAGE:

IMMEDIATE
O 261221Z JAN 81 ZFF-4
FM AMEMBASSY TOKYO

TO SECSTATE WASHDC IMMEDIATE 5599

~~S E C R E T~~ TOKYO 01345
NDDIS
E.O. 12065: RDS-1 1/26/11 (SHERMAN, W.) OR-M
TAGS: NATO, PL, US, JA
SUBJECT: POLAND--VIEWS OF U.S. ADMINISTRATION
REF: STATE 19314

1. (ENTIRE TEXT).
2. MOFA EUROPEAN BUREAU DEPUTY DIR GEN DONOWAKI, IN RECEIVING LETTER FROM SECRETARY TO FOR MIN ITO JAN. 26, PROMISED TO DELIVER IT TO HIM IMMEDIATELY. DONOWAKI SAID THAT SINCE FOR MIN HAD BEEN SOMEWHAT OUT OF TOUCH WITH POLISH SITUATION DURING HIS RECENT LENGTHY TRIP TO SEVEN NATIONS, LETTER WOULD SERVE VERY USEFUL PURPOSE OF BRINGING ISSUE AGAIN TO HIS PERSONAL ATTENTION. MOREOVER, AS FIRST MESSAGE FROM SECRETARY TO FOR MIN, IT DRAMATIZED NEW ADMINISTRATION'S GREAT CONCERN ABOUT POLAND. DONOWAKI EXPECTED FOR MIN ITO WOULD BE REPLYING TO LETTER SHORTLY.
3. DONOWAKI TOOK OCCASION TO WELCOME IDEA THAT AUSTRALIA AND NEW ZEALAND WERE ALSO BEING INVOLVED CLOSELY IN ALLIED CONTINGENCY PLANNING ON POLAND. IN THIS CONNECTION HE SAID THAT IF RELYING ON EC COUNCIL PRESIDENT TO INVOLVE JAPAN IN CONSULTATIONS SHOULD SOVIETS INTERVENE DID NOT PROVE TO BE FEASIBLE (TOKYO'S 810), GOJ WOULD HAVE NO PROBLEMS TO EMERGENCY MEETING OF "EXPANDED SUMMIT" WHICH INCLUDED AUSTRALIA AND NEW ZEALAND AS WELL.

DECLASSIFIED
NLS F00-037/1 #7
BY HJS, NARA, DATE 7/24/06

*****S E C R E T*****

DATE 02/03/81

WHITE HOUSE SITUATION ROOM

PAGE 002

MESSAGE (CONTINUED):

4. DONOWAKI ADDED THAT DURING THE MINISTERIAL MEETING IN TOKYO LAST WEEK, AUSTRALIAN FOR MIN TOLD ITO THAT AUSTRALIA AND NEW ZEALAND WOULD HAVE GREAT DIFFICULTY IN APPLYING EMBARGO ON FOOD EXPORTS TO USSR UNLESS OTHER EXPORTERS, SUCH AS BRAZIL AND ARGENTINA, ALSO AGREED TO APPLY SANCTIONS. MANSFIELD

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*****S E C R E T*****

RECEIVED 26 JAN 81 16

TO ALLEN

FROM GREGG

DOCDATE 26 JAN 81

KEYWORDS: JAPAN

ECONOMICS

SUBJECT: CONTINUATION OF JAPAN / US ECONOMIC RELATIONS GROUP

ACTION: FOR INFORMATION

DUE:

STATUS C

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NATIONAL SECURITY COUNCIL

INFORMATION

January 26, 1981

MEMORANDUM FOR: RICHARD ALLEN

FROM: DON GREGG *DG*

SUBJECT: Continuation of Japan/US Economic Relations Group

Attached is the report to the President of the US and the Prime Minister of Japan prepared by the Japan/US Economic Relations Group (the so-called "Wise Men"). I sat in on the meeting earlier this month when the report was passed to Mr. Mondale. All those at the meeting urged that the group be continued.

I have read the report with some care and fully support this group's continued existence. Japan/US relations, as you are well aware, are very complicated and it is highly valuable to have a joint group of senior people that can speak unsparingly to both the Japanese and American governments.

The Department of State is now trying to reprogram funds to allow the Wise Men to continue. OMB, when it learns of this effort, may ask you what your view is. This note constitutes a suggestion that OMB be told that the Wise Men are a very worthwhile effort that deserves continued funding support.

Attachment

Don
 I do not intend to
 continue Wise Men operation
 I'll tell you why.
 Let's talk at Staff
 mtg. as previously
 2/10/81

THE WHITE HOUSE

WASHINGTON

January 21, 1981

MEMORANDUM FOR: RICHARD ALLEN

FROM: HENRY OWEN *HO*

SUBJECT: US-Japan Economic Relations Group

Attached is a copy of the report of the US-Japan Economic Relations Group (The "Wise Men") which was presented to Vice President Mondale on January 7, plus a summary report of that meeting. As you will see, the Group offered specific suggestions, not generalizations, about how the two governments can improve the management of their economic relations.

The Wise Men have served useful purposes in putting specific recommendations to the Japanese government (e.g., for ending Japanese agricultural protectionism) that it would have been difficult for the US to put forward on a government-to-government basis. It is increasingly difficult politically for the Japanese government to take actions that are believed to have been urged on it, even privately, by the US Government. The Wise Men by contrast, are seen by the Japanese public as part of their own establishment, since they include Japanese members of great prestige. Hence it is difficult for a Japanese government to be seen not to be taking their recommendations seriously.

I gather from Henry Nau that there may be some concern as to whether the Wise Men will offer Japan advice which differs from that of the US Government. In my experience, the US members of the Wise Men are responsive to US Government views. They are an effective conduit through which we can convey needed suggestions to Japan, rather than a loose cannon ball on the deck of a ship.

If the Group goes out of existence, we will lose the services of a prestigious lobbying group within Japan that can put pressure on the establishment there to make policy choices that Japanese politicians would otherwise avoid. One measure of this pressure is the extensive Japanese media coverage that was given to issuance of the report and the fact that Prime Minister Suzuki publicly instructed his Foreign Minister to hold a meeting with appropriate Ministers to study it.

Henry Nau also asked me what I would think of putting the group on a wholly private basis. This depends on what is meant by private:

-- The members are already private citizens who serve without compensation.

-- There would be advantage in having the two-man staff made up of private citizens, instead of State Department officers on detail, as at present. This hinges, however, on getting more money; the State Department officers are free.

-- Private financing has been sought for the Group, principally from the Ford Foundation. The Foundation's view was that since the Wise Men were set up to advise governments, they should be financed by governments. The attempt to secure private financing should be renewed, but this will take time.

-- An essential public ingredient of the operation, which should be maintained, is the charge that was laid on the Wise Men to report directly to heads of government. This is what gives them their prestige and makes it possible to recruit first-class members for the Group.

But the first thing is to get OMB to provide interim financing for the Group now, since its present funding expires January 30. Interim OMB financing would provide time either to get new money from the Congress or to seek private financing.

cc: Henry Nau

REPORT OF THE JAPAN-UNITED STATES ECONOMIC RELATIONS GROUP

Prepared for
the President of the United States
and the Prime Minister of Japan

January 1981

The Japan-United States Economic Relations Group

REPORT OF THE JAPAN-UNITED STATES ECONOMIC RELATIONS GROUP

Prepared for
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and the Prime Minister of Japan

January 1981

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Foreword

The Japan-United States Economic Relations Group, consisting of eight private citizens of the two countries, was established pursuant to a joint communique of May 2, 1979 from the late Prime Minister Ohira and President Carter. The purpose of the Group is to examine factors affecting the bilateral economic relationship over the longer-run and make recommendations to the President and the Prime Minister designed to strengthen it.

The Group's chairmen are Ambassador Nobuhiko Ushiba, former State Minister for External Economic Affairs, and Ambassador Robert S. Ingersoll, former Deputy Secretary of State. Other members are Akio Morita, Chairman, Sony Corporation, Shuzo Muramoto, President, Dai-Ichi Kangyo Bank, Ltd., Kiichi Saeki, Chairman, Nomura Research Institute, A. W. Clausen, President, Bank of America, Hugh T. Patrick, Professor of Economics, Yale University, and Edson W. Spencer, Chairman, Honeywell, Inc. Joint consultations among all members took place in Washington in December, 1979, Tokyo and Oiso in May, 1980, Honolulu in August, and San Francisco in November. The Group was substantially aided by small and effective staffs and a series of commissioned background studies in both countries.

During the past year, the Group examined a broad range of bilateral and multilateral issues relating to Japan-United States economic relations. The members have consulted with a wide segment of organizations, private and official, and with many individuals in both Japan and the United States so that their views could be considered in the discussion and recommendations. The Group came away from its work with a strengthened conviction that the bilateral economic

relationship is of tremendous importance to the future security and welfare of both countries, and indeed to the world. The Group believes that the current economic and political relationship between the two countries is, in general, healthy and mutually rewarding. To enhance the relationship and improve the two countries' ability to meet shared global challenges, however, the Group has addressed a broad set of problems. These include such matters as inadequate consultative mechanisms between the two governments, mistaken or outdated perceptions of each country in the other country, inadequate American economic performance, lagging liberalization of the Japanese market, unresolved energy issues, and the politicization of economic and trade disputes. All too often, both governments and their respective private sectors have failed to face up to difficult problems.

Given its purposes, most of the Group's recommendations are addressed to the President and the Prime Minister and directly concern the two countries' relations. Others, such as those on improving United States productivity and on the internationalization of Japan, are directed primarily to just one government and appear more domestic in nature, but will have an important beneficial effect on United States-Japan economic relations. Still other recommendations are addressed to the private sector since in the market oriented private enterprise system of both countries, it is consumers, management, and labor that ultimately determine the success of the economic relationship. The Group believes that implementation of all its recommendations, while some are politically difficult, is in the long-term national interests of both countries and will enhance the relationship between them.

Executive Summary

Over the past year, the Japan-United States Economic Relations Group has examined a broad range of bilateral and multilateral issues relating to the two countries' economic relations. We have found that a generally healthy economic and political relationship exists between Japan and the United States, but that a number of problems need to be addressed to improve the bilateral relationship and enhance the effectiveness of the two countries in cooperatively dealing with global challenges. These problems included inadequate consultative mechanisms between the two governments, mistaken or outdated perceptions of each country in the other country, inadequate American economic performance, lagging liberalization of market access in Japan, and, all too often, a failure by the governments and private sectors in both countries to face up to difficult problems.

I. THE UNITED STATES—JAPAN ECONOMIC RELATIONSHIP IN A GLOBAL CONTEXT

Because of their broad international ramifications, many of the problems affecting United States-Japan economic relations are not amenable to bilateral solutions. Progress in solving these broader economic problems, however, rests heavily on a close, effective, and comprehensive partnership between Japan and the United States, the two largest market economies in the world.

This partnership should be based on three principles:

- The relationship between Japan and the United States involves shared responsibilities for the management of the international economic and political order.
- Japan needs to develop and articulate a new, more active international role.
- The United States needs to recognize more fully the implications of the postwar diffusion of power and the demands of a more interdependent world.

In implementing these basic principles, it is important to adhere to key guidelines such as those provided by GATT and similar existing international agreements.

Close intergovernmental relations are the key to developing a stronger sense of global responsibilities and addressing interrelated aspects of bilateral and global issues.

- A review of existing consultative mechanisms shows the need for closer and more regularized consultations at all levels.
- Beginning in 1981, there should be periodic joint meetings of cabinet officials of the core departments and ministries dealing with foreign relations, trade and industry, energy, agriculture, and financial and monetary issues.

To improve the effectiveness of their bilateral cooperation and strengthen their ability to work together on global problems, both Japan and the United States need to develop new international roles and to "internationalize" their societies.

- In order to make more reliable and effective the cooperation and coordination between Japan and the United States with regard to security as defined by the terms of the Japan-United States Security Treaty, Japan should clarify its defense role, strengthen its self-defense capabilities, and shoulder a more equitable burden with the United States in attaining comprehensive security. Japan must contribute to both regional and world security, specifically by augmenting economic cooperation with Third World countries, and undertaking diplomatic and political initiative and leadership.
- The United States must improve the quality of its consulta-

tions with its allies, including Japan. Because domestic political considerations often put a premium on prompt, decisive, and unilateral presidential action, it will require strong leadership and some political sacrifice to forego unilateral policy decisions in favor of increased consultation with allies.

- Both governments should improve training in international affairs for civil servants (especially those in more domestically oriented ministries and departments).
- Encouragement should be given to increased and even more intensive and effective contacts and communications among business leaders in Japan and the United States through existing mechanisms and economic organizations as well as through new channels as appropriate.
- There should be increased joint policy research activities and intensified exchange programs for legislators, business and labor leaders, and others in the public and private sectors.

II. BASIC ELEMENTS OF THE ECONOMIC RELATIONSHIP

The United States-Japan economic relationship is of substantial benefit to both countries by stimulating competition, expanding product choices, adding to available capital and technology in each country, and increasing overall economic efficiency. At the same time, there are inevitable frictions over such matters as changing patterns of competition in particular industries, bilateral merchandise trade and current account imbalances, the handling of foreign exchange rate fluctuations, and efforts to coordinate macroeconomic policies. The President and the Prime Minister should play a more active role in improving public understanding of the causes and implications of bilateral and global economic interdependence.

- In particular, there needs to be a better understanding of the reasons for trade and current account imbalances. There have been serious adverse consequences of a continued, narrow United States focus on the bilateral trade imbalance.
- The trade imbalance reflects structural differences between the two countries and would exist even if there were perfect

access to the Japanese market for American products or if American economic policies were well managed. It reflects an efficient allocation of resources for the two countries.

- Current account balances are affected by many factors, including changes in energy costs, the interaction of domestic demand and world business cycles, and differences between domestic savings and investment rates.
- Better criteria than trade and current account balances in evaluating a nation's economic policies and performance include stability and predictability of its macroeconomic policies, its avoidance of unfair trade practices, access to its markets, its avoidance of using exchange rate policies to promote its exports and its trade, worker retraining, and other positive adjustment measures to solve domestic problems of adjustment to the system of international competition.
- Because savings in Japan seem likely to remain relatively high compared to domestic investment demand, it is likely that Japan will have a long-run tendency to run a current account surplus and thus be a capital exporter.
- While Japanese capital exports will benefit the world, the United States will continue importing large amounts of manufactured goods from Japan. Japan should avoid sudden surges of exports in specific products which cause serious injury to American or other foreign firms.

Exchange rate fluctuations have been particularly wide in recent years. The efficient operation of the floating exchange rate adjustment mechanism requires a well balanced, long-rate perspective within government monetary institutions.

- Japan should continue its trend toward greater responsibility for the maintenance of the international financial system by further improving capital liberalization and sharing the responsibilities of a key currency country.
- Exchange rate stability requires also stable, predictable macroeconomic policies, control of inflation and improved productivity performance in the United States.

Attempts to tightly coordinate macroeconomic policy and set

bilateral macroeconomic targets have proved ineffective in the past as well as politically controversial.

- The United States and Japan should consult closely on macroeconomic policies, but avoid attempts at tight coordination.
- There need to be new forums for macroeconomic consultation at both the cabinet and working levels.

III. THE IMPACT OF ENERGY ON THE RELATIONSHIP

Cooperation or conflict in energy policies may well be the most important test of the viability of the American-Japanese partnership. A high degree of energy interdependence requires more intense consultations on all aspects of the energy problem.

- A ministerial level joint committee should be established to meet at least once a year on a regular basis to review and coordinate the disparate consultations now carried out in various other forums and address energy problems in a comprehensive manner.

One of the most critical threats to the security and economic well-being of both countries is the possibility of a major interruption in petroleum supplies. The two governments are simply not prepared to deal with this threat.

- It is imperative that the two governments immediately undertake a crisis management study and formulate specific measures to be taken in the event of a large-scale supply interruption.
- Contingency planning should be expanded as quickly as possible to other major petroleum consuming countries.
- The United States and Japan should take the leadership in strengthening the capacity of the International Energy Agency to deal with both large-scale and small-scale supply interruptions and coordinate stockpiling policies.
- To improve the efficiency with which currently available

petroleum supplies are transported and used, there should be a change in United States policy to allow Alaskan oil which is surplus on the United States West Coast to be exported to Japan in exchange for other oil already committed to Japan.

To develop alternative supplies of energy supply, there needs to be very substantial research and development in energy related technologies.

- Both governments, but especially Japan, must make a much greater effort in energy research and development. A substantially augmented Japanese program would not only help equalize the burden, but be an important contribution to meeting Japan's global responsibilities.
- No alternative source of energy can be overlooked. Both governments and their private industries should accelerate nuclear power development, including the use of the fast breeder reactor as it becomes economically feasible.

Because of vast United States coal reserves, coal offers a particularly attractive basis for substantially augmented United States-Japan energy cooperation. Both countries can benefit from further development of United States mines and exports to Japan.

- The two governments should foster an environment that will encourage investment by the private firms of both countries in coal development, including mining, transportation facilities, and coal gasification and liquefaction in the United States.
- The two governments should explore possibilities for bilateral arrangement embodying secure access to markets for American coal in Japan and American assurance of coal supply to Japan.

Increased United States exports of oil, coal, and nuclear energy materials will improve the bilateral trade balance between Japan and the United States.

IV. AMERICAN PRODUCTIVITY AND THE MANAGEMENT OF THE UNITED STATES ECONOMY

As long as the United States economy suffers from inflation, low savings rates, low rates of capital formation and investment, inadequate expenditure on research and development, burdensome regulation, and low productivity growth, the United States-Japan economic relationship will face severe strains. Improved United States management and strengthening of the supply side of its domestic economy could be one of the most important factors in improving United States-Japan economic relations.

To improve productivity, the following steps should be taken by the American government:

- Productivity should be a major focus of United States economic policy. To do this, the President should convene a White House National Productivity Conference.
- Economic policies should foster a non-inflationary, stable economic climate, conducive to investment and improvements in productivity.
- The President and Congress should develop specific longer-term programs to improve savings and investment rates such as investment tax credits, the reduction of personal and corporate and capital gains taxes in a non-inflationary manner, and the shortenings of depreciation schedules.
- The President and Congress should adopt new programs to stimulate research and development and innovation.
- The American government should reduce the regulatory burden and make productivity a principal consideration in the formulation and implementation of regulations.
- The United States government should sponsor a comprehensive research program on the measures Japan and other foreign countries have taken in the public and private sectors to increase productivity.

Given the proper economic environment, it is the primary responsibility of the private sector to improve productivity performance. The following steps should be taken in the private sector:

- United States corporate management should make long-term productivity improvement a principal objective, building productivity considerations into corporate objectives, management attitudes, and management compensation programs.
- Management and labor should consult closely on productivity trends and problems and on opportunities for improving productivity performance.
- Corporate and labor leaders in both countries should establish joint programs to enhance productivity and increase bilateral understanding of shared problems.

V. JAPAN'S MARKET: OPEN OR CLOSED?

The American perception of the Japanese market as closed to foreign business has contributed to tensions in the bilateral relationship.

- In terms of tariffs and quotas, the Japanese market is as open as the American market for comparable manufactured goods.
- In terms of government procurement practices, foreign investment rules, entry of services, and procedures for standards, inspections, and testing, Japan's market is not as open as the American market and more needs to be done to liberalize market access in Japan's own national interest.
- There are special difficulties for foreign business in Japan from more intangible factors such as administrative procedures, traditional business customs and mores, and cultural and social barriers to foreign influence.

To improve market openness in Japan and the foreign perception of the Japanese market as open, the following measures should be taken:

- The recently enacted, more liberal Foreign Exchange and Foreign Trade Control Law should be implemented by the Japanese government in ways fully consonant with the principle of freeing foreign transactions from restraint. Exceptions to this principle allowable in the new law should be

invoked only in genuine emergency situations.

- Both governments should implement the GATT government procurement code and cooperate in seeking to increase its coverage in later renegotiations of the code.
- The Prime Minister should establish a powerful central office for the consideration and resolution of trade and investment issues. This office should deal with broader policy issues as well as company-specific complaints.
- The two governments should provide support and financial assistance to the Trade Study Group, a voluntary group of American and Japanese governmental officials and businessmen in Tokyo who have played a major role in identifying trade barriers and bringing together foreign and Japanese business and Japanese governmental authorities to resolve trade problems.
- Japan should make its economic decision-making processes more publicly visible, like those of the United States. There should be additional opportunities for private sector access to these processes.
- American businessmen need to improve their efforts to gain access to the Japanese bureaucracy.

VI. INDUSTRIAL TRADE ISSUES

Competition in industries such as textiles, automobiles, steel, and electronics products has been a major source of controversy in United States-Japan trade relations. Trade protection is not an appropriate remedy for industrial trade problems. In general, it delays economic adjustment and hurts the ability of the protected industry to meet the demands of international competition. It also can seriously injure the overall competitiveness of an economy by increasing rates of inflation. Protectionist measures are also contrary to consumers' interests in lower prices, wide choice of designs, quality, and services.

The following basic principles should govern industrial trade relations:

- The two governments should foster a stable, non-inflationary investment climate which encourages economic growth and

facilitates adjustments.

- Both governments should maintain policies promoting a world free trade and investment environment.
- Both governments should adhere to the principle of equal national treatment in programs relating to industries.
- There should be a clear understanding in both countries of foreign industrial policies and specific industrial problems. There should be periodic bilateral discussions between Japanese and American governments on trade and investment restrictions, liberalization programs, implementation procedures, and industrial programs.
- There should be bilateral business, labor, and government dialogues, consonant with law, to identify and discuss potential industrial trade issues before they become major disputes.
- Both governments need to be more conscious of the international implications of domestic economic policies.
- Corporations, especially in the United States, need to have a longer-term, more internationally oriented perspective.

Free trade and investment policies should be maintained for all industries, including the steel, automotive, and semiconductor industries.

VII. AGRICULTURAL TRADE ISSUES

Mutually beneficial economic interdependence is nowhere more evident than in the case of agricultural trade, but steps need to be taken to further open the Japanese market to foreign agricultural products, restructure Japanese agriculture to make it more efficient and competitive, and to improve food security for Japan.

- Japan should continue to shift away from the use of quantitative restrictions on agricultural imports and to ultimately eliminate them by redirecting support policies so that international prices are more adequately reflected in determining the level of domestic price supports.
- Japan should continue to encourage the expansion of the land rental market to help increase the average size of farms

and strengthen the position of full-time farmers.

- The fear of food shortages in Japan is very real, but food security cannot be guaranteed through high protection of inefficient agriculture except at extremely and unacceptably high social and financial costs.
- To increase food security, Japan should establish a more adequate wheat and feedgrains reserve.
- The United States and Japan should enter into negotiations leading to medium-term supply and purchase arrangements.

VIII. PROBLEMS IN U.S. TRADE LAW AND THE UNITED STATES-JAPAN ECONOMIC RELATIONSHIP

There is concern in Japan that recent changes in American trade laws have moved in some areas in a protectionist direction and may act as a non-tariff barrier to trade. At the same time, many Americans believe that these laws are fully consistent with international codes, provide legitimate defense for domestic industries against unfair trade practices, and are needed to support an overall liberal trade policy.

- Because of the differences of opinions in this area, both governments should undertake an examination of American and Japanese trade laws and practices.
- Similar efforts should be carried out on a private basis among specialists in both countries.
- As a long-term measure, the two governments should provide leadership in further strengthening international codes dealing with injurious trade practices.

IX. ECONOMIC DISPUTES AND POLITICAL FRICTION

United States-Japan economic and trade issues have often become serious political issues in both countries, jeopardizing valuable cooperation in non-economic as well as economic arenas. Both governments

should make strong efforts to contain politicization of inevitable instances of economic friction.

- Officials in both countries should improve their knowledge of and sensitivity to the domestic political situation of the other country in order to avoid highly visible political conflict.
- Especially on the United States side, there is a need to discard misleading images, such as that of "Japan, Inc."
- On the Japanese side, there is a need for government, media, and other leaders to put American political statements and Congressional actions in a broader perspective.
- Americans must be sensitive to the use of what appear to be heavy-handed pressuring tactics. Japan should respond earlier to "softer" signals and not invite pressure.
- Each side should avoid using the other as a scapegoat despite the short-run political benefits of sometimes so doing.
- United States officials should beware of intruding too deeply into Japanese economic decision-making, particularly on issues normally considered domestic in nature.
- Japanese negotiators should speak up more, countering American criticism as squarely as possible, to minimize misunderstandings or misperceptions of their position.
- A cardinal principle in American-Japanese diplomacy in the future should be an effort to negotiate on the basis of mutual and reciprocal benefit.

X. CONCLUSION

The sheer size of the United States-Japan share of the global economy and world trade requires the maintenance of a close, mutually rewarding economic relationship. It is vital to both countries and the world. Yet, in any bilateral relationship as encompassing, intense, and diverse as that between Japan and the United States, there will inevitably be some differences in national interest and, therefore, occasions for bilateral tension. What is essential is that these occasional differences be viewed in a broader, long-term perspective, addressed directly and resolved in a mutually beneficial manner, and not be permitted to imperil the overall relationship.

In its work, the Group could not examine all of the many challenges the two countries face in their economic interactions with each other and the rest of the world. We chose to give attention first to those issues which have been most visibly troubling the United States-Japan economic relationship. We feel that a number of potentially important problems need further attention. These include not only issues of trade relations and differences in the structure of the two economies, but also those involving the shared global responsibilities of a more comprehensive United States-Japan partnership. Continuing attention to these issues in both countries is the best guarantee of a healthy long-term United States-Japan economic relationship.

The United States-Japan Economic Relationship in a Global Context

The United States and Japan are the largest and second largest industrial democracies. Both nations have a vital stake in the preservation and promotion of a stable world order favoring the survival and prosperity of societies based on principles of law, non-aggression, popular sovereignty, and private entrepreneurship. As great trading nations, both are fundamentally dependent on open world trade and monetary systems. Both are vitally concerned with securing adequate supplies of energy and raw materials at reasonable prices and in the economic development and political stability of developing countries.

Aside from their shared interests in the international economic and political order, Japan and the United States have an important and mutually beneficial bilateral relationship. One measure of this is the value of the two way trade between the two countries, which will reach \$50 billion in 1980. The United States is Japan's largest trading partner, buying 25 percent of Japan's merchandise exports and Japan is the second largest foreign market for the United States, purchasing 10 percent of U.S. exports. Another measure is the very close security relationship, underscored by the existence of the United States-Japan Security Treaty of 1960. A third measure is the two way steady stream of private citizens and government officials moving between the two countries for consultations on almost every facet of public policy.

A bilateral relationship involving so much and so many forms of interaction cannot be free of friction. Paradoxically, shared interests, presumptions of close cooperation, and intense interaction can create differences and tensions which countries less closely linked would be

unlikely to experience. Because the United States and Japan share similar, but not identical, perspectives on and interests in developments in the world at large and because they try to cooperate on many international issues, differences can arise on how such issues should be approached, the respective roles and responsibilities of each country, and the actual and appropriate degrees of burden sharing. Because each nation has its own language, history, culture, and values, there are some differences in objectives and perceptions as well as some problems in communications.

While frictions between the United States and Japan are inevitable, particularly in their economic interrelationship, it is essential that these frictions be managed so they do not obscure the overriding importance of common interests, or prevent constructive cooperation in fostering the kind of international order in which both societies thrive.

TOWARD A COMPREHENSIVE PARTNERSHIP

The Japan-United States Economic Relations Group has been assigned by the President and the Prime Minister to find ways to improve the management of the United States-Japan economic relationship. This relationship does not exist in a vacuum. Many of the challenges of the United States-Japan economic relationship are multi-lateral as well as bilateral in nature, such as the need to deal with oil supply and price problems, global inflationary pressures, and new stresses on the international trade and monetary system. Because of their broad international ramifications, many of the problems affecting the United States-Japan economic relationship are not amenable to bilateral solutions. But progress in solving the broader problems of international economy rests heavily on a close and effective bilateral partnership.

The bilateral economic relationship is linked also to shared political and security concerns. Perceptions of burden sharing in the political and security areas affect the way the two countries approach bilateral economic problems. Similarly, perceptions of the economic balance between the two countries affect mutual expectations with respect to political and security matters. These linkages should not be overdrawn. There is no simple relationship between economic capabilities on the one hand and political or security capabilities on the other. The

multiple issues facing the two countries should be considered first and foremost on their own merits. But the existence of some degree of linkage among these various dimensions is a political reality.

During the past decade, the United States, Japan, and the rest of the world have been adjusting to new patterns of multipolarity in the international arena during this period. The growth of Western Europe and Japan have led to greater equality among the advanced countries in wealth and economic power and, as corollary, to a relative decline in the position of the United States. As a result, old patterns of unilateral American leadership of the non-communist world have had to yield to new and often less orderly patterns of consultation and negotiation among allies of more equal stature.

Energy problems, slower world economic growth, global inflation, and challenges to the political order have clearly demonstrated the need for the industrial democracies to establish new modes of enhanced cooperation based on a more equitable sharing of the burdens of sustaining an international order in which democratic governments, market-based economies and a liberal international economic system can prosper.

The Group believes that the long-term well-being of the United States and Japan requires a flexible, comprehensive, and outward-looking partnership, attuned to the realities of the altered power relationship between the two countries, and encompassing global as well as bilateral economic, political, and security concerns. The American-Japanese partnership should not be a closed one, but open to maximum cooperation with other countries sharing the same ideals and interests.

This new partnership should be built around three basic principles:

- The relationship between Japan and the United States involves not only bilateral and reciprocal obligations, but also shared responsibilities for the management of the international economic and political order.
- Japan needs to develop and articulate a new and more active international role, based on a broader vision of its self-interests.
- The United States must recognize that its national interests require it to come to grips with the global diffusion of power and the realities of interdependence.

In implementing these basic principles, it is important to adhere to key guidelines such as those provided by GATT and similar existing international agreements.

In the following pages, we will discuss these basic principles in greater detail.

SHARED GLOBAL RESPONSIBILITIES

Some of the long-term issues of the 1980s can be foreseen. Energy issues, which we will discuss in more length in Chapter III, will remain a serious challenge to the industrialized nations. Japan, the United States, and other nations will need to develop new sources of supply, strengthen programs to cope with supply emergencies, and undertake strong conservation programs.

Another set of issues relates to the rapid industrialization of the "newly industrializing countries (NICs)," including Korea, Taiwan, Brazil, and a number of other economies. While the rise of the newly industrializing countries is a welcome reaffirmation of market oriented principles and contributes to world order, it also creates difficult domestic adjustment problems for mature economies and hence, new strains on the international economy.

There will be continued demands in the coming decade by the developing countries for advanced country foreign assistance, market access, technology transfers, and commodity stabilization programs to assist their development. Japan and the United States should work together and with other developed countries to accommodate legitimate interests of the developing countries on the basis of mutual benefit.

Japan and the United States will have a continuing interest in coordinating their economic and political policies toward non-market economy countries. While they have generally pursued parallel and cooperative policies with respect to East-West economic relations, leaders of both countries need to be aware of the possibility that policy divergencies could emerge as a result of the different geographical and economic positions of Japan and the United States and the different weights each may assign to political and economic factors in dealing with non-market countries.

Both nations have a strong interest in the future direction of China.

China's new openness to joint ventures with foreign firms and its approaches to international trade have created substantial new business opportunities. It is both natural and healthy that there will be vigorous competition among Japanese and American firms in responding to the opportunities. At the same time, because of the interest of the two countries in China's modernization, it is also important that a sense of common purpose prevails between them at the policy level.

Many of the other issues of the 1980s cannot easily be predicted. Undoubtedly, there will be continued challenges to international peace and the principle of non-aggression, as occurred in 1979 when the Soviet Union intervened in Afghanistan. In this case, Japan and the United States cooperated in boycotting the 1980 Moscow Olympics and in economic sanctions against the Soviet Union, and Japan increased its foreign assistance to Pakistan. Japan and the United States will be called upon increasingly to consult and act cooperatively on political issues on the basis of the mutual sharing of responsibilities for maintaining international order.

We believe that to enhance the sense of shared global responsibilities and improve public awareness of the value of their close bilateral relationship, Japan and the United States should reaffirm the fundamental importance of their alliance.

Too often the tensions rather than the underlying shared and complementary interests receive public attention. It is essential that there be better mutual appreciation of common perspectives, values, interests, and actions in pursuit of those interests.

Consultations are key to developing a deeper sense of shared global responsibilities, increasing each government's understanding of the sensitivities, interests, and political realities of the other government, and providing a broader framework for addressing interrelated aspects of the bilateral and global issues. While consultative mechanisms are not a substitute for or guarantor of good policies, they increase the chances of mutually desirable policy outcomes.

Our review of existing consultative mechanisms has led us to the conclusions that there need to be closer and more regularized consultations between the two governments at all levels — summit, cabinet, subcabinet, and working level — and on a broad range of issues. Obviously, these consultations will be most intense at the lower levels. It is essential, however, for the cabinet level officials to be acquainted with their counterparts and with the problems of the other country. We

recommend that there be periodic joint meetings that would bring together the cabinet officials of the core departments and ministries dealing with foreign relations, trade and industry, energy, agriculture, and financial and monetary problems. The first such meeting should be held in 1981 as the new United States Administration begins its work, and thereafter whenever there are significant changes in either country or the international situation. Other cabinet officials should be brought into these meetings as needed. We recommend elsewhere in this report other more regularized forms of consultation in the fields of macro-economic policy, energy, productivity, and industrial and agricultural issues which could be held in conjunction with these meetings.

The new United States-Japan partnership should contribute to international security in its broadest terms for the benefit of both countries. In this context, security can be regarded as the maintenance of peace, the preservation of a liberal international economic system, and the promotion of an international political order in which democratic governments and the principle of individual rights are respected.

The provision of security requires the use of various kinds of resources — political, economic, military, and even cultural. It is not necessary that Japan and the United States use the same mix of resources in carrying out their respective role in a new and comprehensive partnership. Clearly, each country's role needs to be backed by its respective society at large, and it is a political fact of life that some societies find it more difficult to provide one kind of resource rather than another. The important point is not that the contributions to the overall international security by the United States and Japan be identical, but that they be complementary in nature and more equitable. Japan and the United States should consider the most efficient means of dividing their international responsibilities in accordance with their respective capabilities.

While it is not appropriate for the Group to make detailed recommendations on the exact division of international responsibilities between Japan and the United States, it is useful to suggest some of the general directions.

JAPAN'S NEW ROLE IN INTERNATIONAL AFFAIRS

Japan's present international role is not commensurate with its

economic size or with the global reach of its interests. A new partnership with the United States, based on a more equitable sharing of international responsibilities, will require a substantially greater effort by Japan in all fields. The Group strongly believes that Japan's own national interests require it to take up a larger burden in maintaining a liberal international economic order and international stability. We will discuss the security, political, and economic dimensions of Japan's new role.

For constitutional and political reasons, it is not realistic or prudent to expect Japan to undertake a sudden, major expansion of its military forces. We believe, however, in order to make more reliable and effective the cooperation and coordination between Japan and the United States with regard to security as defined by the terms of the Japan-United States Security Treaty, Japan should clarify its defense role, strengthen its self-defense capabilities, and shoulder a more equitable burden with the United States in attaining comprehensive security. Japan must contribute to both regional and world security, specifically by augmenting economic cooperation with Third World countries, and undertaking diplomatic and political initiative and leadership. In addition, Japan can and should continue to explore ways to further expand its share of the financial cost of maintaining American forces on its territory.

For its part, the United States must be sensitive to the political constraints on Japan in the military area, not to mention the strategic limitations inherent in Japan's geographical situation. Unfortunately, much of the public debate between Japan and the United States regarding defense has focused on Japan's military spending as a percentage of gross national product (GNP). This is not a very satisfactory indicator of the adequacy of Japan's defense effort and overemphasis on it tends to divert attention from sober discussions of security threats and defense requirements and onto one of the most sensitive issues in Japanese domestic politics. We believe it is far more fruitful to consider the adequacy of Japan's self defense efforts in relation to its security requirements and overall resources rather than simply in relation to an arbitrary figure derived from GNP.

Japan should make a proportionately much larger contribution in the political and economic fields, because Japan will inevitably bear a smaller proportion of the military burden of international security. A major element of this cost will be an expanded foreign assistance

program to the developing world. Not only should Japan's foreign assistance program be enhanced in quantitative terms, but it also needs to be improved qualitatively. At the present time, Japanese foreign aid is too closely tied to Japanese commercial interests and too geographically concentrated in regions where Japan has substantial economic interests. If Japan's foreign aid programs are to be recast in terms of a framework of overall security, the redistribution of aid might favor countries in Africa or South Asia where Japan's economic interests are smaller, but where assistance is needed to promote general political stability. In this respect, the major increases in aid to Pakistan and Turkey in recent years are welcomed. The United States should also cooperate in this field. It is noteworthy that more than half (55 percent) of Japanese aid is untied. We encourage both governments to further untie their aid.

In the political field, Japan's diplomacy has been often characterized by passivity and reluctance to take a forthright stand, even when an international principle of political issue important to Japan has been involved. As Japan's economic importance has grown, the passive nature of its diplomacy has been increasingly challenged. It should not be necessary for other countries to have to cajole or pressure Japan into taking political or diplomatic positions where Japan's own interests are involved. We believe Japan should develop a more active foreign policy in accordance with an enlightened, broad view of its global interests in international peace and an open trading system.

A NEW AMERICAN ROLE

Like Japan, the United States has been slow to adjust to an altered global environment. The United States expects, and properly so, that its allies will play an increasingly significant role in defending an open international economic and political order. If allies are going to be committed to sharing the burdens and responsibilities, they must also share in the definition of the goals to be pursued and determination of means of implementing those goals. On too many issues, the United States has taken policy positions in advance of its allies and only later sought their support. Since the American position did not take into account adequately the interests and sensitivities of the allies, they may be reluctant to give full support. A subsequent and often very public

debate occurs in which the United States appears to be pressuring its allies to accept its position, and its partners appear to be resisting.

This not only creates an image of disunity, weakening the effectiveness of the alliance, but reinforces stereotypes in public opinion of a "bullying" United States and "selfish" allies.

The effectiveness of free world action and the commitment of all partners to coordinated policies, will be maximized by close and genuine consultation at early stages. While consultation and policy coordination have been given considerable attention in American rhetoric, the practice of American diplomacy has left much to be desired. Domestic political considerations put a premium on a president appearing to act promptly, decisively, and hence unilaterally. It will, therefore, require both strong American political leadership and some political sacrifice to forego unilateral policy decision in favor of increased consultation and coordination with allies, but we believe the long-term national interests of the United States require it.

Consultation does not mean that the United States need always concede to allied points of view and even to seek a consensus among its allies before taking action on matters affecting its own interests. It does suggest, however, that the United States make a maximum effort to discuss its interests and policy considerations with its allies ahead of time and seek to accommodate their perspectives and interests to the extent possible consistent with its own interests.

INTERNATIONALIZING THE AMERICAN AND JAPANESE SOCIETIES

New American and Japanese international roles can be sustained only by enlightened and outward-looking public and private sector leadership and by domestic societies conscious of their nations' global interests and supportive of the kinds of policies needed to maintain a harmonious bilateral relationship and pursue common international objectives.

The Group believes that concerted, long-term efforts are needed to make American and Japanese governmental and political leaders, businessmen, and individuals in other parts of the private sector more aware of each other's society and more conscious of their own societies'

role in the world community.

In both governments, there is still a lack of civil servants trained in the culture of the other country and aware of its economic and political interests. Many officials in more domestically oriented ministries and departments have little interest in or concern about the impact of their work or decisions on the rest of the world. Yet in an increasingly interdependent world, decisions regarding transportation, environment, domestic energy programs, health and safety regulations, and a host of other presumably "domestic" issues can have significant international economic or political repercussions. We recommend that each country take steps to train more specialists on the other country and that each government utilize those resources in its major political and economic departments or ministries. The United States particularly needs to develop its competence in this area.

To improve mutual understanding of the political decision-making processes of each other's country, we also recommend that each government should make available to the government officials of the other country short, in-country educational programs on its government, economy, and society.

Legislatures play a major role in both international and domestic decision-making processes. Moreover, because legislators are public opinion leaders, it is important to the United States-Japan relationship and to each country's international role that they be knowledgeable about the other country.

We recommend that there be expanded parliamentary exchange between members of the Congress and the Diet. In addition to private exchange programs, there should be established an official, annual United States-Japan parliamentary meeting, similar to existing programs between the Congress and the parliaments of Canada, Mexico, and the countries of the North Atlantic. Such meeting should be constructed around a definite agenda of issues.

Business leaders play an important role in United States-Japan relations, and have a significant influence on economic policy making in both countries. We would hope that both American and Japanese businessmen would develop more informed and long-term perspectives on the bilateral and international aspects of the United States-Japan relationship.

Encouragement should be given to increased and even more intensive and effective contacts and communications among business

leaders in Japan and the United States through existing mechanisms and economic organizations as well as through new channels as may be appropriate. Such efforts should include cooperative schemes such as sharing of knowledge and experience on energy conservation in industrial processes and on productivity improvement and also joint research and seminars on the legal framework of bilateral trade and on potential industrial trade issues.

The role of private educational, research, cultural, and philanthropic institutions in internationalization of both societies should also be emphasized. Private institutions not burdened with day-to-day dealings with immediate international issues nor constrained by the need to pursue more narrowly defined national interests are uniquely capable of developing policy alternatives in a longer-term and international perspective. Bilateral or multilateral joint programs by such institutions can contribute greatly to the opening of the two societies to each other and the rest of the world. Similarly, these institutions can be effectively engaged in promotion of public understanding of international policy issues, and in developing human resources with knowledge and expertise for international activities. While such programs have been increasing in both countries, we are deeply concerned about the inadequacy of these programs compared with more rapidly growing needs caused by increasing international interdependence. We recommend that each government substantially increase its attention to and financial support for international programs and institutions dedicated to promoting such programs. In the United States, there are pressing domestic problems which have to be addressed, but it is in the interest of all the Americans that international problems not be neglected.

In Japan, there should be greater government encouragement of private sector efforts in international affairs programs and international education. We believe that Japan, like the United States, should provide tax incentives for private, non-profit institutions engaged in international activities.

Basic Elements of the Economic Relationship

The United States-Japan economic relationship is the source of substantial benefit for both countries. The similarity and complementarity of the two largest economies in the free world provide enormous market opportunities and an important competitive stimulus through trade, capital, and technology flows.

The increasing interaction of the two economies is also the source of recurrent economic and, not infrequently, political tension. Changing product trade patterns, merchandise trade and current account imbalances, foreign exchange rate fluctuations, and attempts at coordinated macroeconomic policy intervention have brought about domestic economic disruptions and political problems in both countries.

The successful management of the bilateral economic relationship requires an understanding of the underlying causes and implications of our increasing global as well as bilateral economic interdependence. Nations which are structured and managed to operate in this competitive, interdependent world economic environment have prospered more than nations which have been unable or unwilling to make the necessary domestic economic and political adjustments.

The purpose of this chapter is to discuss the bilateral economic relationship in broader and longer-term perspective, and to develop recommendations to enhance the benefits and reduce the conflicts inherent in our global and bilateral economic interdependence.

GLOBAL AND BILATERAL ECONOMIC INTERDEPENDENCE

The interaction of the United States and Japanese economies takes place within the context of an increasingly interdependent global economic system. In the last decade world trade has grown by 424 percent from \$572.5 billion in 1970 to a projected \$2,998 billion by 1980.

For the United States, international trade has become much more important to its overall economy. The ratio of United States exports of goods and services to GNP has increased substantially from 6.7 percent in 1970 to 12.1 percent in 1979 while the share of imports of goods and services in GNP has increased from 6.1 percent to 11.9 percent in the same period. Most of this increase was in non-oil imports. United States oil imports increased from 0.3 percent of GNP in 1970 to 2.5 percent in 1979. However, since the United States economy grew less rapidly than the world economy, its share of world exports declined from 15.1 percent in 1970 to 12.2 percent in 1979.

Japan's trade shares have moved less dramatically. Japan's exports were 11.3 percent of GNP in 1970, 12.6 percent in 1979. Imports, 10.2 percent of GNP in 1970, were 13.3 percent in 1979. Japan's share in world exports was 6.8 percent in 1970; it increased only slightly to 6.9 percent in 1979.

The United States-Japan economic relationship parallels the global trend toward increasing interdependence. In the 1970s bilateral trade grew 376 percent from \$10.5 billion in 1970 to an estimated \$50 billion in 1980. Each country is the other's largest overseas trading partner. United States trade with Japan is roughly equal to United States trade with West Germany, France, and England combined. Japanese trade with the United States is larger than Japanese non-oil trade with Asia and almost double Japanese trade with Europe.

The increase in the value of bilateral trade does not fully reflect our growing bilateral economic interdependence. Japanese dependence on imported agricultural commodities and raw materials and United States comparative advantage in these products are important factors in bilateral relations. Japan is the largest market for United States exports of many of these products, and the United States is Japan's largest supplier of agricultural commodities.

Both countries are also increasingly dependent on bilateral trade

in manufactured goods as a consequence of healthy intra- and inter-industry specialization and the gains specialization brings. Each country is the other's largest supplier of manufactured goods. For 1980, United States manufactured goods exports to Japan are expected to reach nearly \$70 billion, and Japanese manufactured exports to the United States are estimated at \$280 billion. This deficit in manufactured goods overwhelms the large surplus the United States maintains in agricultural commodities and raw materials and leaves the overall bilateral merchandise trade in substantial deficit for the United States. The size of this deficit has been subject to large cyclical swings over the years.

Bilateral merchandise trade is only one aspect of the United States-Japan economic relationship. The fastest growing sector in both countries is in service industries, now accounting for more than half of GNP in the United States and Japan. Traditional industries such as banking and other financial services, insurance, transportation, and communications are expanding, and new industries such as electronic data processing and computer software are becoming increasingly important.

Bilateral service trade, principally investment income, and financial, transportation, and insurance service income is an important part of the United States-Japan economic relationship. Japanese data provide more comprehensive coverage than American data. They indicate that United States service exports to Japan have increased from \$2.6 billion in 1970 to \$12.5 billion in 1979. Japanese exports of services to the United States have also increased rapidly from \$2.0 billion in 1970 to \$9.9 billion in 1979. The bilateral balance on services trade rose from \$644 million to \$2.6 billion in favor of the United States during the same period. The United States data show smaller amounts of bilateral trade in services and a smaller United States bilateral surplus.

The increase in bilateral economic interdependence is also reflected in the growth in long-term capital flows, both portfolio and direct investment. Through the 1960s, foreign investment in Japan had been largely restricted to minority joint venture participation. As a result, the percentage of foreign investment in Japan is extremely low compared to that in other advanced industrial countries. Nevertheless, United States direct investment in Japan has increased from \$1.48 billion book value in 1970 to approximately \$4.8 billion by

the end of 1980. This represents 3 percent of total United States foreign investment, and 60 percent of foreign investment in Japan.

Japanese foreign investment has grown dramatically in the last decade from a total of \$2 billion in 1970 to \$16 billion in 1979. The favorable balance of payments position, an appreciation of the yen, the relaxation of Japanese foreign investment restrictions, the increasing international competitiveness of Japanese firms, and the growing international position of Japanese financial institutions have all stimulated this increase in Japanese overseas investment.

Japanese direct investment in the United States has increased from \$0.2 billion in 1970 to \$3.4 billion in 1980. Japanese investment in the United States currently provides 7 percent of total foreign investment in the United States. Increasingly, Japanese investments are moving toward long-term investment rather than more traditional portfolio and other short-term dollar denominated assets. Continued healthy growth of Japanese direct investment can be expected.

SOURCES OF BILATERAL ECONOMIC AND POLITICAL CONFLICT

The benefits of United States and Japanese economic interdependence have not been without economic and political costs. Individual industry trade issues, merchandise trade and current account imbalances, foreign exchange rate fluctuations, and attempts at coordinated macroeconomic policy intervention have contributed to certain domestic economic dislocations and political problems in both countries.

A certain amount of short-term economic dislocation is the inevitable cost of global interdependence. The interaction of international trade and capital flows with such domestically generated phenomena as changing demand patterns, changing availability and costs of capital and labor, and technological change force domestic economic adjustment. This process of structural adjustment will benefit consumers through better products at lower prices and open new export markets to domestic producers. At the same time when OPEC extracts petrodollars from importing countries by its market power and when domestic macroeconomic mismanagement results from the complication of greater international economic interaction,

inevitable global interdependence can have serious adverse consequences.

Some of these economic problems and much of the resulting political tension can, however, be ameliorated through deeper appreciation of the dynamics of trade and capital movements. However, better understanding simply leading to increased patience on the part of policy makers and the general public is not enough. Improved working of existing adjustment mechanisms and new mechanisms are also necessary.

One source of bilateral economic and political conflict is shifts in competitive trade patterns in specific industries. We discuss this problem in Chapter VI. In this chapter, we review three other major sources of bilateral economic tensions.

The Bilateral Trade and Global Current Account Imbalances

Data on the respective global current positions of the United States and Japan and the bilateral merchandise trade balance are given in Table 1.

Among the most politically divisive issues in United States-Japan trade relations is the singular and simplistic focus in the United States on the bilateral merchandise trade imbalance. As the recent House Ways and Means Trade Subcommittee Report on United States-Japan Trade issued on September 5, 1980 noted,

"From an economic point of view, a bilateral merchandise trade deficit should not be an object of great concern, as long as a nation's worldwide current account (goods and services) is in rough balance. This economic truth is a political falsity."

This statement underlines the need for the Administration and the Congress to play a more active role in educating their colleagues and the public on the benefits of world trade, the global character of trade and capital flows, and the necessary adjustment processes implicit in global economic interdependence. The Group is concerned about the adverse economic and political consequences of a continued, excessively narrow United States focus on the United States-Japan bilateral merchandise trade balance. It is unrealistic and divisive. It encourages the United States' other trading partners to use the same

TABLE 1

	Global Current Account Position		Bilateral Merchandise Trade Balance		Total Trade	
	U.S.	Japan	U.S. data	Japan data	U.S. data	Japan data
	(billions of dollars)					
1970	2.3	2.0	-1.2	1.5	10.5	10.5
1971	-1.4	5.8	-3.2	3.4	11.3	11.6
1972	-5.8	6.6	-4.1	4.0	14.0	13.9
1973	7.1	-0.1	-1.3	1.3	18.8	17.5
1974	2.1	-4.7	-1.7	1.9	23.0	23.5
1975	18.3	-0.7	-1.7	1.0	20.8	20.8
1976	4.4	3.7	-5.3	5.5	25.7	25.7
1977	-14.1	10.9	-8.0	8.6	29.1	30.1
1978	-14.3	16.5	-11.6	10.7	37.3	38.7
1979	-0.8	-8.8	-8.6	7.6	43.8	44.4
1980*	0 to +5	-13 to -15	-9.9	n.a.	51.0	n.a.

* Estimated

Note: The United States has a deficit in bilateral trade, Japan a surplus.

Sources: Current account:

U.S.— *Survey of Current Business*

Japan— *Balance of Payment Monthly*

Bilateral Merchandise Trade:

U.S.— *Department of Commerce, Bureau of Census, FT 990*

Japan— *Balance of Payment Monthly*

argument against the United States to reduce their own bilateral trade deficits with the United States. A country is properly concerned about its trade and capital flows with the rest of the world as a whole, not with bilateral balances. Just as an individual derives income from one source and spends it elsewhere, a country has bilateral surpluses with some countries and deficits with others.

Even global trade and current account balances should not be fundamental national economic goals with the same status as low unemployment, price stability, and improvements in the standard of living. Balance in the inflows and outflows in either of these two accounts need not necessarily be a goal at all. Countries, like individuals, find there are times when it is desirable to invest more than they are saving and, therefore, to borrow from others. It makes sense for some countries to be capital importers and others capital

exporters. Such imbalances may well reflect real economic benefits for a country, depending upon domestic and international circumstances.

Accordingly, merchandise trade and current account balances are not only rough indicators, they may be misleading measures of the state of American or Japanese international economic relations. Better criteria for evaluating whether or not a country's behavior is beneficial to the operation of the international economic system are the extent to which:

- (1) its macroeconomic policies are stable and predictable;
- (2) market tactics and strategies of its companies do not involve dumping, subsidies, collusion, or other unfair activities or disruptive injury to trading partners;
- (3) access to its market for foreign goods, services, and assets is promoted on a reciprocal basis with trading partners;
- (4) its exchange rate policy is not manipulated to promote exports and reduce imports; and
- (5) its trade policy responds to domestic dislocation caused by international competition stress positive measures of structural adjustment assistance and worker retraining rather than protectionist measures.

The Bilateral Merchandise Trade Imbalance

Structural differences between the two economies are an important source of the United States-Japan merchandise trade imbalance. Japan is highly dependent on imported energy, agricultural products, and raw materials, only partially supplied by the United States. Japan must pay for these imports by exporting manufactured goods. The United States is the world's largest market for manufactured goods and purchases one-quarter of Japanese exports. While the United States has greatly increased its raw materials and manufactured exports to Japan, the composition of its export is very different from Japan's import structure. For example, 40 percent of Japan's imports are oil and the United States at present does not export oil.

Any significant change in the structure of bilateral trade would require major changes in the structure of the two economies as well as a change in global trade flows. This is neither politically realistic

nor economically rational for either country. To a substantial degree the bilateral trade imbalance reflects an efficient allocation of resources for both countries.

Even if there were perfect access to the Japanese market for American products, Japan would still have a large bilateral merchandise trade surplus with the United States. The removal of the remaining Japanese barriers will not significantly change trade patterns in the short-term. This is clearly stated in the introduction of the recent Special Progress Report of the United States-Japan Trade Study Group, a binational government and industry joint study committee:

"We recognize that even the total elimination of non-tariff barriers would not have a dramatic impact on United States-Japan trade, at least in the short-run. There are more fundamental and difficult steps to be taken to reduce the trade imbalance, particularly on the side of the United States."

While this statement is true, the size of the bilateral imbalance can respond to changes in the actual openness to foreign trade of the Japanese economy. Chapters V and VII review the question of the relative openness of the Japanese economy.

Solutions to the problems hindering further United States export growth are even more important in a global context than that of the bilateral trade imbalance. Even so, the Group believes one of the most important factors in the bilateral trade relationship is the management and performance of the United States economy, particularly government and industry policies toward exports. No change would improve the United States-Japan economic relationship more than an improvement in the fundamental strength of the United States economy. Chapter IV in this report addresses these issues in greater detail.

In addition, United States exports to Japan and indeed to all the world are inhibited by a lack of United States business attention to foreign market opportunities and by government disincentives to exporting. Industrial exports account for a noticeably lower percentage of GNP in the United States than any other advanced industrial country. Much of American business has traditionally had little interest in foreign markets. The size and familiarity of the American domestic market, combined with ignorance about foreign markets, have deterred

American firms from realizing important foreign market opportunities. In addition, a variety of United States laws and government policies tend to make exporting less attractive.

Current Account Imbalance

The global balance (but not bilateral balance) on current account is a somewhat more meaningful description of a nation's overall trade position than the balance of merchandise trade. The current account includes merchandise trade, service transactions, and transfers. As Table I indicates United States and Japanese global current account positions have fluctuated widely in recent years as a consequence of massive changes in imported energy costs and subsequent export expansion, the interaction of domestic demand and world business cycles, and differential domestic savings and investment rates. Both Japan and the United States are likely to have current account surpluses in 1981.

The large Japanese current account surpluses in 1977-78 were a major source of bilateral political tension causing the United States and other governments to pressure Japan to reduce its surplus. Japanese efforts to respond did not satisfy its trading partners and aggravated Japan's budget deficit, causing domestic resentment. Japan relied on exchange rate appreciation and sustained economic growth to reduce the surplus over a longer period.

This controversy was politically costly for both countries yet proved neither effective nor necessary. The Japanese actions did not address the fundamental reasons for the cyclical or long-term Japanese current account movements. Other factors, especially the new round of OPEC price increases which raised Japan's oil bill by \$10 billion annually, helped to turn the \$16.5 billion surplus to a \$8.8 billion deficit by 1979. Even before the oil price increases, however, the turnabout had begun. This episode could have been avoided if there had been a broader understanding in both countries of the role of the current account under the floating exchange rate system, and the structural origins of the Japanese current account position.

As is stressed above, a balance in a nation's current account position is not required for either short-run or long-run equilibrium. If a country's expenditures on private consumption, private investment goods, and government are less than its production, the excess of

production will show up as exports and the current account will record a surplus. When its expenditures exceed production, this gap will be met by imports and the current account will record a deficit. Whether an economy is in current account surplus or deficit will depend on the relationship between investment, both public and private, and savings.

Thus, domestic savings and investment patterns in both the United States and Japan have an important impact on their respective trade and current account positions. Japanese savings rates are the highest in the world. OECD data show recent personal and corporate savings at 32 percent of GNP in Japan, and 19 percent in the United States. The ratio of Japanese household saving out of disposable income is almost four times that in the United States.

If, as seems likely, savings in Japan remain high relative to domestic investment demand, Japan will have a long-term current account surplus. In 1979-80 energy price increases and cyclical fluctuations overwhelmed this trend and resulted in a significant current account deficit. These forces may again slow or offset the tendency toward surplus.

Surpluses will inevitably result in net capital outflows from Japan. One important question will be the relative size of the alternative forms of these flows — foreign assistance, direct investment, long-term portfolio investment, and short-term capital movements. The trend toward increasing Japanese exports of capital has important implications for Japanese policies toward domestic capital markets and international financial movements. Japanese financial institutions and the Japanese yen are expected to play an increasingly important international role.

Because saving and investment patterns in the United States and Japan are significantly different, there may well be substantial long-run differences in the impact on their respective balance of payments positions. The future prospects for the United States current account balance appear less clear. Much depends upon the absolute and relative improvements in saving and investment performance. If the United States is to maintain a surplus in its current account over the longer-run while improving its domestic economic performance, private savings will have to increase above the amounts required to finance private investment and any government budget deficits.

The Group urges the President and the Prime Minister to play a more active role in improving public understanding of the cause

and implications of bilateral and global economic interdependence.

The increasing economic interaction between the United States and Japan will continue to generate economic conflicts which must be resolved in ways which encourage competition and cooperation rather than conflict and isolation. Policy makers and the public at large in both countries must learn to put traditional domestic economic issues in a longer-term, international context. In so doing, the bilateral relationship will itself be better managed.

In both countries, administrations and legislatures as well as industry, labor, and media representatives need to understand better the long-term benefits of the bilateral economic relationship and the complex and at times lengthy adjustment process necessary for mutually beneficial economic interdependence.

Americans often mistakenly focus only on the bilateral trade balance and neglect the causes and implications of changing international trade and investment patterns. Many Japanese continue to regard trade and current account surpluses as unqualified policy objectives, without taking into account adequately the implications for other domestic and foreign policy goals.

Leaders need to stress that global free trade and capital flows benefit consumers through wider selections of better products at lower prices, and provide opportunities for producers of exports. At a national level, they encourage economic growth by stimulating higher productivity, efficient use of capital and labor, and economies of scale.

The Group urges both governments to be sensitive to the international effects of sustained large current account surpluses or deficits.

The preceding discussion has pointed out that, depending upon a country's fundamental economic circumstances and policies, it may be efficient nationally and internationally to have large sustained current account surpluses or deficits. This depends upon the successful operation of international capital markets and domestic adjustment and trade specialization.

It appears possible that over the longer-run, Japan, as a high saving nation, will have large current account surpluses. Capital accordingly will flow out of Japan. The Japanese financial institutions and businesses will have to play an important role in making investment funds available, directly as well as indirectly, to non-oil developing nations and others likely to be in current account deficit positions. The

Japanese government should be aware of these trends and encourage these capital flows and not hamper them.

The world is short of savings and capital. Japanese savings and capital export would benefit the world. At the same time, other countries will be importing more from Japan. Given the bilateral trade structures, this implies the United States will continue to be importing large amounts of manufactured goods from Japan. Both governments must be sensitive to the adjustment problems this implies for American industry. In particular Japan should avoid sudden surges of exports of specific products which cause serious injury to American or other foreign firms.

A global Japanese current account surplus implies little about the state of the United States balance of payments. That depends essentially upon the performance of the American economy in competing in domestic markets against imports, in competing in world markets with exports, and in generating domestic saving to finance domestic investment. American leadership in the world would be enhanced by a strong balance of payments position and a strong dollar. This will require domestic macroeconomic and other policies, as discussed in Chapter IV, to strengthen the American economy. Fundamentally, this can only be achieved, of course, through the more effective operation of American enterprises in both domestic and international markets. In both the United States and Japan, government creates the environment and influences incentives; management and labor carry the burden of the actual performance of the economy through the private enterprise, competitive market system.

FOREIGN EXCHANGE FLUCTUATIONS AND ADJUSTMENT MECHANISM

The interaction of the United States and Japanese economies in a turbulent world environment requires an adjustment mechanism to allow for differences in national economic performance, monetary policy, and trade and current account balances.

Since 1973, floating foreign exchange rates have provided the adjustment mechanism for trade and current account positions. Countries which run chronic trade and current account deficits without compensating capital inflows find their currencies depreciating and,

in turn, find import costs rising and export prices improving.

Foreign exchange rate fluctuations as an adjustment mechanism, however, differ from the earlier pegged rates system. The exchange rate moves in response to changes in trade and current account positions and capital flows. Moreover, to a substantial degree the exchange rate depends upon the expectations of those engaging in foreign exchange market transactions on the future course of trade and current account performance and on the monetary and other policies of the authorities. To the extent that such expectations are unstable, the system may well generate quite volatile movements in exchange rates.

The floating foreign exchange rate system also differs from the fixed rate system in terms of the speed and precision of the balance of payments adjustment process. It takes time for the volume of trade and direct investment flows to respond to exchange rate changes. Indeed, the initial effect is to exacerbate the imbalance; the medicine of exchange rate adjustment makes the patient temporarily worse before it cures him. For example, in 1977-78 when the yen appreciated, the dollar value of a given volume of Japanese exports already contracted for in yen increased and the dollar value of yen denominated imports decreased (the so-called J-curve effect). Thus, until trade quantities could respond, Japan's global and bilateral current account surplus in dollar terms increased even as it decreased in yen terms. Because this process and the time it takes has not always been well understood, at times exchange rate movements have overshoot the degree required for correction of the balance of payments, and policy makers and politicians have become frustrated and impatient over the seeming lack of progress.

These problems of exchange rate fluctuations have proven particularly acute in the United States-Japan bilateral trade relationship. In response to the differential international economic performances of Japan and the United States, the yen/dollar exchange rate fluctuated as much as 35 percent within 18 months in 1977-79. The size and speed of this shift accelerated the adjustment process yet over-responded to the magnitude of the bilateral trade imbalance.

The efficient operation of the floating foreign exchange rate adjustment mechanism requires a well balanced, long-range perspective within government monetary policy institutions. Government intervention in foreign exchange markets may be appropriate to moderate

very short-run fluctuations, but should not attempt to impede longer-term movements. Given the enormous impact of foreign exchange rates on domestic monetary policy and trade and capital flows, central banks are always under great temptation to undermine the foreign exchange rate adjustment mechanism rather than make other adjustments.

For example, Japanese government intervention in foreign exchange markets in late 1977 to prevent further appreciation of the yen was perhaps counterproductive. It may have delayed the adjustment process, and contributed to an even greater appreciation before reaching a peak in the fall of 1978. Foreign exchange market intervention is not necessarily inappropriate. The United States dollar defense program announced in November 1979 reversed the decline of the dollar through a coordinated package of foreign exchange market intervention and domestic monetary policy actions. In this instance, the dollar's depreciation had exceeded levels justified by longer-term economic conditions and intervention was appropriate.

In the future, the yen/dollar relationship has the potential to become more stable with the increasing international role of the yen. Japanese government capital liberalization and Japanese bank participation in international syndicates, greater reserve currency and trade use of the yen, increasing petro yen deposits, and larger yen markets will probably moderate short-run fluctuations of the yen exchange rate.

The Group believes Japan should continue assuming the trend toward greater responsibility for the maintenance of the international financial system.

The increasing impact of the Japanese economy on the world economy and the vital importance of a stable international trade and financial system suggest that Japan should share the burdens of a key currency country.

The 1979 Foreign Exchange and Foreign Trade Control Act continues an important Japanese trend in relaxing restrictions on foreign participation in domestic economy and encouraging a greater international role for Japan.

Stability of the yen/dollar exchange rate also depends importantly upon the stability of the dollar. Fundamentally, this can be achieved only by improved performance of the American economy, cyclically and in the longer-run. This requires stable, predictable macroeconomic policies, control of inflation, and improvement in United States pro-

ductivity performance. These themes underlie the policy recommendations for the United States throughout this report and are addressed more specifically in Chapter IV.

POLICY COORDINATION AND SYSTEM MAINTENANCE

Perhaps the most complex issue in the bilateral relationship is how the two countries should attempt to coordinate policy responses to cyclical economic problems in both their bilateral and global manifestations. The appropriate degree of international coordination of domestic macroeconomic policies is extremely difficult to determine.

Simulations of a number of linked, multinational, large-scale econometric models suggest that a variety of coordinated macroeconomic policies might have provided greater exchange rate stability, smaller current account imbalances, and higher production and employment, without much greater inflation. However, there is a real danger that attempts to fine tune the global economic system by coordinating domestic economic policies on such a basis may not be justified by our understanding, may impede domestic economic performance, and exacerbate rather than improve international adjustments.

To study this further, the Group sponsored research on the interdependence of the United States and Japanese economies, the cyclical recurrence of trade and current account problems, and foreign exchange fluctuations. The results confirm the Group's view that attempts to coordinate closely demand management and monetary policies, with efforts to set specific GNP growth and other macroeconomic targets, have not been very effective and may have created unnecessary political problems. Given the lack of political feasibility and our current level of technical knowledge, a less structured form of consultation would have been preferable.

The results of the Group's research provides support for the following conclusions:

- (1) Tightly coordinated macroeconomic policy may at times be counterproductive. Household and corporate expectations have an important impact on macroeconomic behavior.

Where macroeconomic policy coordination becomes the subject of high profile diplomatic and political negotiations, it may distort rather than stabilize these expectations.

- (2) Attempts to set bilateral macroeconomic targets and to coordinate policies tightly for such macroeconomic variables as growth rates of output, savings, investment, and money supply consume enormous amounts of time and political capital, and may have relatively little influence on subsequent national economic performance.
- (3) Synchronizing macroeconomic policies in the interest of improving bilateral relations may work against global stability.

The Group distinguishes between efforts at precise coordination and close consultation on specific macroeconomic targets and policies. Coordination at times implies strenuous efforts by one government to influence the domestic goals of the other, at high political cost, and without adequate final results. Consultation should be used for an honest exchange of information on the current economic situation, future prospects, and thinking regarding appropriate policy actions. In this way each government can take into account its interaction with the other in formulating its own policies. Consultation is important not only in terms of each other's economies, but also in light of common external shocks, particularly those of large oil price increases.

We believe both countries should engage in close consultation but not tight coordination of macroeconomic policies.

The United States government should recognize the limitations of efforts to coordinate macroeconomic policies through international agreement among major industrial countries on precise growth rates and other targets. The maintenance of a stable international economic system requires both good domestic economic performance and general agreement on the framework of the system and its rules, including those for exchange rates and other adjustment mechanisms. What is needed is not unrealistic efforts to agree on specific macroeconomic targets, but close consultations on economic conditions and future policy responses.

At the present time, the annual meetings of the Economic Planning Agency of Japan and the Council of Economic Advisors of the United States serve a very constructive purpose by bringing together senior

economic policy officials in a non-political forum for the exchange of views.

The Group recommends that in addition to these meetings:

(1) there should be annual meetings of the ranking authorities in both governments who formulate and implement macroeconomic policy. Sub cabinet meetings should be held on a regular basis. While their focus will undoubtedly continue to be on current issues, opportunities should be sought for frank exchanges on longer-range issues.

(2) there should be more frequent working level consultations between the professional staffs of the governmental organizations responsible for economic policy. Where appropriate, these consultations should be expanded to include experts from the private sector and academic community.

CHAPTER III

The Impact of Energy on the Relationship

The importance of energy issues in the United States-Japan relationship can hardly be overstated. Since the two countries are the largest consumers and importers of petroleum in the free world, the actions of each have a direct impact on the other and on the rest of the world. Because energy plays such a crucial role in the economies and societies of both countries, in instances of rapid price increases or threats of supply interruption, there are strong economic, political, and psychological incentives for each country to act hastily and independently. The resentments which can arise in such cases constitute a serious threat to the overall strength of the bilateral relationship. Indeed, the most important test of the viability of the United States-Japanese partnership may well be the two countries' ability to sustain strong, effective, and cooperative measures in dealing with current and future energy problems.

It has been estimated that for every \$1 per barrel increase in the price of crude petroleum, United States real GNP growth will be reduced by 0.1 percent and Japanese growth by 0.2 percent. A significant interruption of supply would, of course, have a far more devastating impact.

Both Japan and the United States, therefore, have a vital common stake in securing adequate and stable supplies of reasonably priced energy. Attaining this objective is a major challenge to the industrialized democracies, particularly in the coming decade. While projections of future energy supplies and consumption are often highly speculative, it is likely that future oil supplies will be tight. Oil supplies could be further jeopardized by political change in one or more export-

ing countries, and the shift to non-petroleum energy sources will take time. Energy, therefore, will remain a critical security and economic issue during the 1980s.

If the United States and Japan handle energy issues poorly, major tensions could be introduced into the relationship. Properly handled, energy represents a significant opportunity to deepen United States-Japan cooperation. For these reasons, the Group believes it essential that Japan and the United States try to anticipate potentially serious problems, such as supply interruptions or large price increases, and plan coordinated approaches to deal with such problems. For the longer-term, they should work together to eliminate the threat of energy crises by increasing production, especially from alternative energy sources, and improving energy conservation.

ENERGY INTERDEPENDENCE

The United States and Japan consume approximately half (30 percent and 20 percent respectively) of the 26.5 million barrels of petroleum which the advanced industrialized countries of the OECD (Organization for Economic Cooperation and Development) import each day. Given their size in energy markets, there is a high degree of interdependence between them and with much of the rest of the world. Energy interdependence has many different dimensions, including energy prices, supplies, domestic energy policies, and foreign political and economic policies. American decontrol of domestic petroleum prices, for example, has been welcomed in Japan as a step toward increasing domestic American production and reducing consumption, thus reducing American pressure on world oil markets. Speculation by some Japanese companies in spot market purchases of Iranian oil in late 1979 following the taking of American hostages in Iran was severely criticized in the United States on both economic and political grounds. A failure of American policies in the Middle East could have a strong influence on energy supplies in Japan. If Japan fails to curb its energy imports, this would increase its need to export manufactured goods, affecting American industry and United States-Japan economic relations. If the United States fails to curb petroleum imports, its growing dependency could weaken its overall international credibility and its value as an alliance partner for Japan. Indeed, there is virtually no

significant policy issue relating to energy that can be considered as purely domestic by either country. Each country has a very high stake in the energy and energy-related policies of the other.

The United States and Japan have similar or complementary interests on many energy issues, such as avoiding oil supply disruptions, maintaining the political stability and the international security of petroleum exporting countries, building up petroleum stockpiles, stimulating development of new energy sources, and diversifying sources of supply. But they often have different approaches to the achievement of these objectives, in part because of their different energy situations and resulting different priorities. As a country far more dependent on external energy sources, Japan has less flexibility and gives energy security issues an even higher priority than the United States. This has led to misunderstandings and controversy in the past, on, for example, the two countries' different postures in the Middle East and different approaches toward the development of nuclear energy, and could do so again. Consequently, a high degree of interdependence requires more intense consultations on all aspects of the energy problem.

The Group believes that it is important for the two countries to enhance the frequency, quality, and scope of inter-governmental consultation on energy policy and policy implementation. We recommend the establishment of a ministerial level joint committee to meet at least once a year on a regular basis to review and coordinate the disparate consultations now carried out in various other forums and address energy problems in a comprehensive manner.

These meetings might be timed to coincide with present International Energy Agency (IEA) ministerial meetings and the cabinet level consultations we recommend in Chapter I.

We also recommend that a small standing committee be established to provide backup for the ministerial committee and assure that energy issues are addressed in a long-range and broad context.

Inter-government work on energy issues should be complemented by broad programs of private level policy research on all aspects of energy interdependence. We recommend that both governments increase their funding for joint energy policy studies to be carried out in private institutions. Such joint research will reinforce habits of cooperation on energy issues consistent with an age of increasing energy interdependence.

ENERGY SUPPLIES: A CRITICAL SECURITY ISSUE

One of the most serious threats to the security and economic well-being of both the United States and Japan as well as to their close relationship is the possibility of a major interruption in petroleum supplies. As the 1979 Iranian crisis demonstrated, a political change in even a medium-sized exporter can have a significant impact on supplies and prices of petroleum in the industrialized world, affecting rates of growth, inflation, and employment. A study by the United States Congressional Budget Office estimates that just for the United States, a year-long supply interruption of 3.5 million barrels per day in 1984 would cause real GNP in the United States to drop by 6.6 percent (\$272 billion), while unemployment would increase by 2 percentage points and inflation by 20 percentage points.

A supply interruption of this magnitude would have a much more shattering effect on Japan. The United States depends on petroleum for only half its total energy requirements, and half of that is derived from domestic wells. Fifteen percent of United States petroleum needs are supplied by Persian Gulf oil producing countries. In contrast, petroleum accounts for 75 percent of Japan's total energy requirements and virtually all has to be imported. Almost 78 percent of Japan's petroleum needs are supplied by the politically fragile Persian Gulf region.

In any consideration of American-Japanese energy cooperation, the importance of Japan's much greater degree of energy vulnerability must be fully recognized. For Japan, the threat of an interruption of petroleum supplies is the emotional equivalent of the Soviet threat for the United States. American policies regarding petroleum, coal, and nuclear energy development as they relate to Japan have not been sufficiently sensitive to this Japanese energy concern, creating apprehensions in Japan about United States policy in a serious energy emergency. On the other hand, Japan's energy policies have often been too exclusively focused on its own national oil supply interests to the detriment of a more encompassing sense of international responsibilities, including broader political and security issues and considerations.

The Group is deeply concerned about the failure of both governments to adequately and comprehensively address energy security and supply issues. We believe several steps should be urgently undertaken:

(1) The President and the Prime Minister should exercise strong leadership in stressing to their citizens the seriousness and fragility of the

world energy situation.

(2) It is imperative that the two governments immediately undertake a crisis management study and jointly formulate specific measures to be taken in the event of large-scale supply interruptions. A wide range of emergency scenarios should be considered, including the possibility of a prolonged interruption of Persian Gulf petroleum. The Iran-Iraq war, although apparently limited in nature, illustrates the urgency of carefully planned and multilaterally coordinated steps, agreed to ahead of time, to cope with supply emergencies. Prior planning will strengthen the effectiveness of countermeasures and help defuse what would undoubtedly be very strong domestic pressures for independent action at the time of an energy emergency. The danger of a catastrophic supply interruption is so serious that we believe the governments of Japan and the United States should undertake planning immediately on a bilateral basis and expand emergency planning as quickly as possible to include other major petroleum consuming countries.

(3) As the two largest energy consumers, Japan and the United States should take the initiative in strengthening the OECD/IEA framework to address broad aspects of energy security in a more comprehensive and effective fashion. Current multilateral and bilateral discussions have tended to focus almost exclusively on petroleum, but should be expanded to include other energy sources as well. There also needs to be improved coordination of stockpiling policies. At the present time, stockpiles vary widely in different consuming countries; Japan's of about 100 days of consumption is considerably larger than the United States Strategic Petroleum Reserve of only 15 days of imports plus company-controlled stock of 25 days of imports. Larger stockpiles will not only help in coping with a prolonged crisis, but will also help in ameliorating the initial psychological impact of a large-scale supply interruption. More evenly distributed stockpiles would help prevent charges of unfairness that could be raised during an emergency.

The Group is also concerned that the IEA emergency sharing program does not deal sufficiently with small-scale interruptions of supply. The Iranian oil crisis of 1979-80 showed that even relatively small-scale interruptions can have a significant effect on worldwide petroleum prices, causing political concerns, economic distress, and international tensions.

We recommend, therefore, that the two countries continue their efforts to improve the capability of the IEA to deal with interruptions

of less than the 7 percent figure that now triggers the petroleum sharing plan. Both countries should also improve domestic mechanisms for prompt implementation of policies adopted in emergency situations.

OTHER PETROLEUM POLICIES

Aside from the above steps, there are other ways in which Japan and the United States can increase the efficient use of currently available petroleum supplies and maximize energy conservation.

One of the most obvious of these relates to Alaskan North Slope petroleum. Alaskan oil can now be made available to the West Coast of the United States in quantities exceeding refining capabilities in that region, but it cannot be efficiently transported to the East Coast and mid-sections of the continental United States. Current American law and policy prevent the export of Alaskan oil to other countries, like Japan, where it could be transported economically, even in return for other petroleum that could more cheaply be transported to the eastern parts of the United States. Energy economists have estimated that significant efficiencies could be achieved through swapping arrangements, beneficial to consumers in both the United States and in Japan.

(1) We recommend the United States modify its petroleum export policy to permit the sale of Alaskan oil to Japan in return for the sale (or swap) of other petroleum now committed for export to Japan. A change of American legislation or an exercise of the waiver authority in current legislation permitting swapping would have an important symbolic effect on American-Japanese relations, give credibility to the concept of petroleum-sharing, help reduce the bilateral imbalance of trade, and represent a more efficient and less expensive use of Alaskan oil by cutting transportation costs.

Both governments should intensify their effort to conserve the use of all energy, especially petroleum. From 1973 to 1979, crude oil imports of the United States increased from 3,244,000 barrels a day to 6,397,000 barrels a day. During the same period, Japan's crude oil imports decreased slightly from 4,992,000 barrels a day to 4,846,000 barrels a day. The per capita total energy requirements of the United States remain almost three times those of Japan. While the economic structure, geographic size, and lower population density of the United States make continued higher per capita energy and petroleum use

very likely for a long time to come, there is clearly much additional room in the United States for petroleum conservation measures. Japan also can augment its conservation programs, particularly in the case of its highly energy-intensive agricultural sector.

(2) We applaud the commitments to conservation made during the past two Economic Summit Conferences. In addition, the Group recommends that the United States learn from Japan's progress in developing an effective petroleum conservation program. Recognizing the importance of competitive market forces, the United States and Japan should develop annual industry-by-industry comparisons of energy use and savings, and draw from each other's experiences in promoting conservation in industrial processes through existing or new private binational industrial organization.

ENERGY RESEARCH AND DEVELOPMENT

Effective solutions to the energy problem in the long-term require the United States and Japan to diversify their sources of energy and, particularly, to develop non-petroleum energy sources and related technology. Before discussing specific alternative energy sources, it should be emphasized that the development of all alternative sources will require very substantial funding. Both governments have increased their support for energy research and development and related technology, but the American government is currently making a much more substantial effort. IEA statistics for 1979 shows that the United States government spent \$3.7 billion in energy research and development, while the Japanese government spent \$0.9 billion, about half the American amount on a per capita basis.

The Group recommends that both governments, but especially Japan, make a much greater effort in energy research and development. A substantially augmented Japanese program would not only help equalize the burden, but also be an important contribution to meeting Japan's global responsibilities.

A maximum effort should be made to coordinate American and Japanese energy research and development programs, although a certain degree of duplication is not only inevitable but also desirable. Given their different energy situations, the two countries have different priorities in terms of alternative energy sources, and research and

development cooperation should be developed with complementary priorities in mind.

Energy research and development inevitably involve both the government and the private sector. The nature of the relationship between the government and the private sector varies in the two countries, particularly at the commercialization phase of new technologies. The two governments should discuss with each other and with their respective private industries means of developing compatible structures of government-private industry energy cooperation to facilitate efficient use of the private sectors of both countries in joint or complementary research and development projects.

NUCLEAR ENERGY

Japan's energy policy gives a high priority to the development of nuclear power as an alternative source of energy. Indeed current government plans anticipate that nuclear energy will supply 14 percent of Japan's energy needs by 1995, making nuclear energy the third largest source of energy after petroleum and coal. Japan's ambitious nuclear fuel cycle, must be understood in light of Japan's higher degree of energy vulnerability. For Japan, nuclear energy provides the energy source least dependent on other countries.

A major and unfortunate dispute occurred in 1977 when the United States, because of a general policy of discouraging nuclear processes which might result in nuclear weapons proliferation, refused to export material for Japan's almost completed pilot reprocessing plant at Tokaimura. Japan has a strong policy in support of non-proliferation and there is no question of Japan using plutonium to acquire a nuclear weapons capability; rather it was a question of whether American worldwide restrictions would be credible if an exception were made for Japan. Eventually a compromise was reached allowing the Tokaimura facility to start up on a limited basis.

Japan has also been concerned about the basic health of the American nuclear energy industry which has played a major role in the development of Japan's nuclear energy program. There is a fear in Japan that American government restraints on domestic development of nuclear energy will affect the industry's ability to assist in Japan's program.

The Group strongly believes that in the current energy situation, neither country can afford to overlook the efficient development of any alternative energy source. We recommend that both governments and their private industries move forward to fully utilize the potential of nuclear energy. We recommend that the President and the Prime Minister accelerate nuclear power development, including use of the fast breeder reactor when it is economically feasible. The two governments should work together to demonstrate the feasibility of permanent disposal of nuclear wastes to answer questions of legitimate public concern. In both countries, cooperation should be intensified on improved reactor safety systems. In addition, Japan and the United States should continue to strengthen national, bilateral, and multilateral safeguards as part of their common objective to prevent nuclear weapons proliferation.

COAL AND OTHER ALTERNATIVE FUELS

Coal offers a particularly attractive basis for reducing dependence on Middle East petroleum supplies, expanding alternative energy sources, and improving the bilateral trade balance. Both countries intend to increase their use of coal as an energy source, but Japan has limited coal reserves, while the United States produces half of the coal in the non-communist world. Both countries can very substantially profit from further exploitation of the reserves of the United States and exportation of coal to Japan. Because coal development requires large-scale investments, this will be furthered by assurances to American coal producers of secure access to the Japanese market and by Japanese coal consumers of a secure source of supply from the United States. At the same time, such arrangements must take into account Japan's desire to purchase coal from a diversity of sources (Australia currently is Japan's major supplier) and at competitive prices.

(1) Both governments should take steps that would facilitate substantial and profitable private investment in mines, transportation, and utilization facilities. Substantial Japanese private investment in the further development of the American coal industry would be very desirable. Governments have a direct obligation to improve harbor facilities. As a first step, the United States should expeditiously resolve environmental and transportation issues relating to coal. Japan should

resolve environmental issues related to its expanded use of coal.

(2) Both governments should also seek to develop new forms of coal gasification and liquefaction through innovative technological development. The jointly sponsored SRC-II liquefaction project is a useful model for further cooperation by government and private industry in synthetic fuel development. It should be recognized that rapid commercialization of such technologies will depend on market forces and prevailing energy prices.

(3) The United States and Japanese governments should explore possibilities for bilateral agreements combining secure access to markets for coal in Japan with American assurances of supplies.

Given the critical nature of energy supply problems, no alternative source of energy can be neglected. While we believe that nuclear energy and the expanded use of coal represent the most feasible alternatives to petroleum in the nearer-term, a wide range of other energy sources — geothermal, hydroelectric, oil shale, tar sands, biomass, and solar — deserves careful attention from both governments.

CHAPTER IV

American Productivity and the Management of the United States Economy

As long as the United States economy suffers from inflation, low rates of savings and capital formation, inadequate attention to research and development, and an overly burdensome regulatory environment, low productivity growth will continue to cause serious strains to the United States-Japan economic relationship. One of the most important factors in improving our bilateral relationship could well be a fundamental strengthening of the "supply side" of the United States economy.

Recently, there has been a growing interest in the United States in improving United States productivity growth and reinvigorating the industrial base of the American economy. As the national debate in the United States develops, we will be supporting efforts in the Executive Branch and Congress to achieve these goals. Our own recommendations highlight those areas which have a special impact on United States-Japan economic relations, and more broadly, United States global economic performance.

UNITED STATES PRODUCTIVITY AND ECONOMIC PERFORMANCE

The health of United States economy can be measured in a general way by "productivity," or the efficiency with which an economy produces goods and services. Productivity, often expressed in terms of output per manhour or real GNP per worker, is a common statistical indicator used to compare economic performance over time, or between

nations and industry sectors. These definitions focus on labor productivity, although it can also be useful to focus on output per unit of capital, raw materials, energy, or a combination of all such inputs.

However one measures United States productivity, it is clear that the growth in United States productivity and economic efficiency has declined sharply in the last decade. From 1967 through 1973, United States labor productivity in manufacturing rose 2.9 percent a year on average. It slowed to a 1.5 percent average annual rate from 1973 through 1979. Productivity growth in the first half of 1980 declined even further to negative 1.2 percent, reflecting strong cyclical factors as well as long-term trends.

Productivity growth rates have an important impact on United States domestic and global economic performance in three main areas: international trade, domestic inflation, and the domestic standard of living. Low relative rates of productivity growth lead to slow growth in real wages, higher costs, cost-push inflationary pressures, reduced profits, limited capital for investment in new technology and modern plant and equipment, and weaker domestic and global competitiveness.

PRODUCTIVITY AND GLOBAL ECONOMIC PERFORMANCE

United States productivity growth has also declined relative to the rest of the industrialized world as shown in Table 1. In the postwar period, the United States has had the lowest productivity growth rate of any advanced industrial economy. The implications of this long-term trend in productivity growth rates for United States international economic performance are profound. The disparity in United States productivity growth relative to its trading partners is closely related to the decline of the United States share of global markets, and increasing import pressure in the United States domestic markets.

Between 1950-67, United States manufacturing productivity increased at an average annual rate of 2.6 percent and during 1967-73 it grew at an average annual rate of 2.9 percent. In 1973-79, United States productivity slid to a 2.2 percent average annual growth rate, and continued to decline to a low 1.0 percent average annual rate in 1977-79 largely due to cyclical reductions in business output and capacity underutilization.

TABLE 1

INTERNATIONAL COMPARISON OF MANUFACTURING PRODUCTIVITY
(Average annual growth in output per hour, 1950-79)

	1950-79	1950-67	1967-73	1973-79	1977-78	1978-79
United States	2.4	2.6	2.9	2.2	0.5	1.5
Japan	8.5	9.5	10.0	4.2	7.9	8.3
Canada	3.9	4.1	5.1	4.8	4.7	0.8
France	5.2	4.9	6.1	5.1	4.9	5.4
West Germany	5.7	6.1	5.3	5.0	3.4	5.2
Italy	6.0	6.4	7.2	3.3	3.0	2.2
United Kingdom	2.7	3.0	4.2	0.6	1.2	2.2

Source: U.S. Bureau of Labor Statistics

Japanese productivity grew 9.5 percent on an average annual basis between 1950-67 and increased 10.0 percent during 1967-73. In 1973-79, Japanese productivity declined to a 4.2 percent average annual rate due to the first oil shock of 1973 and the ensuing high rate of inflation for several years thereafter. Japanese productivity growth increased in the 1978-79 period to 8.3 percent as the Japanese economy has readjusted to energy price increases and moved to sounder growth based on private investment. We have not studied the sources of Japan's productivity improvement in any detail, although we consider this an important topic for future consideration. It is at least clear that the recovery and increase of productivity after the oil shock of 1973, and in spite of the second oil shock of 1977 and thereafter, far surpasses that of the other countries, particularly that of the United States. This is the point to which we must pay close attention in our study.

The impact of these global productivity trends have been obscured in the short-term by currency devaluations, protectionist trade measures, and significant differences between aggregate productivity levels and the productivity of individual industries and firms. While the aggregate United States level of productivity is high, in some industries such as steel, automobiles, and consumer electronics, the United States is no longer the world's most efficient producer.

Productivity will determine future global competitiveness which

will, in turn, determine global market share and global trade patterns. The longer-term implications of these differences in recent productivity growth performance, however, must be put in broader perspective.

First, there is an important difference between the *level* of current United States productivity and *rate of growth* of United States productivity. The *level* of United States productivity is still the highest in the world while the average annual *rate of productivity growth* in the United States is the lowest in the industrialized world, causing the gap between the level of United States productivity and the levels of productivity in Japan and Europe to shrink.

Second, decline in productivity growth performance is not limited to the United States. All other advanced industrialized nations are experiencing some relative decline in productivity growth rates as their economies reach an advanced stage of development.

Third, the increases in the level and growth rates of productivity in the rest of the industrialized world are a positive development. It has been in the interests of the United States to develop strong economic partners. In many ways the shrinking productivity gap between the United States and its trading partners reflects the long-term success of United States international economic policy and foreign policy in general.

Finally, it is not at all clear what the future long-term trends in productivity in advanced industrial countries will be, or how United States productivity growth rates will compare with other nations.

In the 1960s there was a great deal of optimism about the impact of rapid advance in technology on long-term productivity trends. The decline in United States productivity growth rates in the 1970s was not anticipated.

In spite of recent productivity performance, there is room for cautious optimism about future growth trends. The major technological innovations of the 1960s and 1970s, such as those in the communications industry, have greatly increased productivity across a wide range of manufacturing and service industries. Many of these innovations, such as those in micro-electronics, have not yet been fully exploited and are expected to provide a major stimulus for significant shifts in the structure and productivity of the economies of the industrialized world.

Much of the diffusion of these new technologies will depend on the current system of international free flows of goods, services, capital,

and technology. Technological development will depend on current research and development expenditures, future economic conditions, and the management of the entire innovation process. A significant factor will be the receptivity and utilization of these new technological and organizational innovations in each country's own socio-economic environment.

PRODUCTIVITY AND INFLATION

The decline in United States productivity growth rates has been an important factor in the acceleration of cost-push inflation in the United States. Table 2 shows recent changes in labor costs and the consumer price index. Price increases stimulate wage increases which lead to unit labor cost increases, which in turn lead to further price increases and fuel inflationary pressures.

Low productivity growth rates also make efforts to unwind the wage price spiral particularly difficult. An increased productivity growth would provide a margin which would allow wage increases to catch up with price increases. Without this margin, wage earners remain pitted against employers in a struggle which passes on and continues the inflationary burden.

The importance of this linkage between inflation and productivity cannot be overstated. Unless the United States can control inflation,

TABLE 2

PRODUCTIVITY AND REAL HOURLY COMPENSATION GROWTH
IN THE U.S.
(Average annual growth rates)

	1948-65	1965-73	1973-78
Nominal hourly compensation	4.6	5.5	9.0
Real hourly compensation	2.9	2.1	0.9
Productivity	2.6	2.0	0.8
Unit labor costs	1.9	4.6	8.1
Consumer price index	1.6	4.4	8.0

Sources: U.S. Bureau of Labor Statistics

all other short-term policy measures to increase United States productivity will be substantially undermined. Effective long-run policies to improve productivity growth require a consistent sacrifice of current consumption and an investment of these resources to productive investment for the future.

REASONS FOR POOR U.S. PRODUCTIVITY GROWTH

There is no consensus about the causes of poor United States productivity growth rates. While experts agree on some factors, others are more controversial. This is certainly true of the slowdown in United States productivity growth in the last decade. Our purpose is not to fuel this debate, but to summarize the results of contemporary research.

The origins of declining United States productivity growth differ industry by industry and firm by firm. No aggregate measure of productivity is an accurate reflection of the differences in productivity growth trends in specific sectors. In 1973–78, average annual productivity increased 6.9 percent in the communications industry, 3.0 percent in agriculture, 1.8 percent in manufacturing, 0.8 percent in service industries, but fell 2.0 percent in construction and 3.7 percent in mining. Nevertheless, a number of generalizations can be made about the reasons for declining United States productivity growth.

Fluctuations in Economic Conditions and Policy Responses

One of the most important reasons for the recent decline in productivity growth is that labor productivity varies considerably over the business cycle. During periods of low or declining demand, firms do not immediately reduce employment because of the expectation of future costs of recruiting and training new workers.

As a result, output declines more rapidly than employment during a downturn, and increases more quickly than employment during a recovery. The combination of these cyclical movements and the lag between output changes and employment levels cause considerable fluctuation in capacity utilization and measured labor productivity.

Two recessions in the past decade have had a major impact on United States productivity growth. Low capacity utilization during

the 1974–75 recession reduced productivity as output declined faster than employment. This decline in productivity was then exacerbated by the 1980 recession.

Fluctuations in government policies have contributed to declining productivity growth. Monetary policy has been unstable, and fiscal policy has experienced considerable mid-course corrections. As various anti-inflation policies of tight money, high interest rates, and fiscal restraint have been introduced and abandoned, private sector concern with instability and inflation has increased. Without a stable, non-inflationary economic climate, neither management nor labor has had an incentive to seek productivity gains as the source of long-term increases in *real* profits and wages.

The mix of fiscal and monetary policies has also led to declining productivity. Fiscal and monetary policy have tended to encourage consumption and discourage investment decisions which would promote productivity. Fiscal policy in the current political climate remains focused on Keynesian demand stimulation with little positive effect on United States productivity. Monetary policy has been used principally to control inflation and support the dollar on international markets.

Energy Price Increases and Investment Distortions

The rapid rise in oil prices in 1973–74 and again in 1979–80 contributed to the decline in United States and global productivity growth rates in two ways. First, the energy crisis was a major factor in bringing on the inflation and recession of the global economy. The repeated shocks of sudden, large oil price increases have made the world a less certain economic environment, and hence new productive investment less attractive.

Second, the rapid rise in energy prices made some existing energy-intensive and energy-inefficient plant and equipment obsolete, and led to a substitution of labor for energy in new investment. This has resulted, in the near-term, in some decline in the productivity of labor. This will lead in time to an increase in the efficiency of energy use in the production process.

This twofold impact of energy prices on investment decisions has important implications for United States relative productivity and global competitiveness. Partly as a result of relatively cheaper

energy prices in the United States and partly as a result of government policy and management decisions, the productivity capacity in the United States is not as energy-efficient as that of its trading partners. The differences in magnitude and direction of investment between the United States and its trading partners suggest that this gap will grow in the future.

Capital-Labor Ratios and Inadequate Capital Formation

Another element in labor productivity growth is the rate of increase in the amount of plant and equipment per worker ("capital-labor ratio"). The capital-labor ratio is determined by the size of the work force, and the magnitude and kind of investment. The more modern plant and equipment each worker has, the more productive he will be.

Throughout the postwar era until 1973, there was a growth in investment in plant, equipment, and technology per worker. The recession of 1974-75 triggered an unprecedented decline in the net capital-labor ratio in 1976-77, reflecting both weak investment in plant and equipment and a rapid increase in employment. Recent capital-labor ratios have not returned to the pre-1974 recession peak.

The direction of United States investment has also changed significantly in the last decade, increasingly concentrated in short-lived assets and investments which have higher short-term returns and make little contribution to basic productive capacity. This shift in United States investment largely reflects uncertainties about inflation and future return on longer-term investments. In addition, in the United States there is too heavy emphasis on short-term financial results and quarterly earnings statements. This may result in management focusing investment decisions on short-range returns, rather than on the long-term health of the business. Annual as opposed to long-range incentive plans for managers also tends to shorten the horizon for investment decisions.

These recent trends in the magnitude and kind of United States investments are in marked contrast to those of United States' trading partners. Japanese investment in plant and equipment as a percentage of GNP is currently twice the United States ratio. Relatively lower rates of inflation combined with generally longer corporate investment perspectives help direct capital toward investments which contribute

to long-term productivity increases.

Declining Innovation and Research and Development Expenditures

The current decline in United States research and development expenditures as a percentage of GNP has long-term implications for United States productivity growth. Research and development, particularly basic research, is the foundation of technological progress and innovation. Low research and development expenditures slow the entire innovation process from basic research through commercial application.

Total research and development as a percent of GNP in the United States has declined from 3 percent in the 1960s to 2.2 percent by the mid-1970s. Reductions in United States government funded research and development have been the principal cause. Private sector research and development as a percent of GNP has remained relatively stable at 1.3 percent of GNP.

The commercial benefits of government funded research and development are difficult to assess in the abstract. And, for many United States industries, the value has shifted over time. The United States semiconductor industry benefitted greatly from the United States space program funded research in the early 1960s. Yet, the current United States government program to develop very high speed integrated circuits for military applications has drawn protest from parts of the United States industry who argue that it may bid up the price for scarce private sector engineering talent without stimulating innovations of commercial interest.

Private sector research and development expenditures, which have remained relatively stable as a percent of GNP, are more closely tied to commercial innovation and, therefore, productivity growth. Yet, in recent years there has been a marked shift in the United States toward a smaller number of smaller projects with lower risks and faster returns.

Much of United States corporate research and development has also become defensive in focusing more on product differentiation and regulatory compliance rather than on developing new products and basic improvements in processes which would improve productivity.

The reasons for this quantitative and qualitative decline in United

States research and development expenditures are the same as those which have distorted all investment in a highly inflationary and unstable economic environment. Investors are increasingly unwilling to take risks and commit resources to the future. This has had an even greater impact on research and development investment because it entails even greater risks and longer payback periods than plant and equipment investments.

Regulatory Environment

An important reason for the recent decline in United States productivity growth has been an antagonistic, burdensome, and highly uncertain regulatory environment. While the health, safety, and environmental objectives are desirable, the costs in productivity growth have been significant.

The most direct cost of the growing regulatory burden has been the deflection of declining investment toward health, safety, and environmental compliance. The benefits of these investments, while important to the nation's long-term economic and social health, are not measured in terms of current labor productivity.

The indirect cost to the United States economy has perhaps been even greater. In addition to diverting capital from productive to non-productive investments, regulations have increased the cost of product development, added to the costs of product liability loss protection and prevention, lengthened product cycles, increased reporting requirements, disproportionately burdened small business, and raised uncertainties and risks in ultimate standards.

Some of the direct investment costs cannot be avoided, and represent a legitimate expense for past failures and future benefits. There are several areas, however, where an improvement in the formulation and implementation of regulations can substantially reduce both direct and indirect costs to United States productivity.

An international comparison suggests that United States trading partners have become more successful in developing and implementing health, safety, and environmental regulations which do not undermine the investment climate and productivity growth.

Intersectoral Employment and Productivity Shifts

A major source of the recent decline in United States productivity

growth has been the structural change in the United States economy from shifting employment and productivity patterns in individual sectors.

The most important structural change in this century has been the employment shift out of agriculture. By the end of the 1960s, the movement of a substantial part of the work force out of a low productivity sector and the subsequent increase in productivity of that sector has been completed. It should be noted that United States agriculture now has the world's highest labor productivity.

One of the most significant structural changes in the United States economy in the last decade has been the relative decline of the manufacturing sector and growth of service industries. The impact of this shift on United States productivity growth is not entirely clear. Some service industries, such as retail trade, have lower than average productivity growth rates. Yet, in other service such as finance and communications, the level of productivity growth is above average.

Changes in Labor Composition

The rapid increase in relatively inexperienced and unskilled workers in the United States labor force also has been a factor in the recent decline of United States productivity growth rates. The rapid expansion of employment in recent years has compounded the impact on productivity growth rates.

These changes in the demographic composition and size of the United States labor force have affected United States productivity growth in several ways. First, new employees generally lack skills and experience, and reduce the average quality of the labor force.

Second, these new employees require an investment in training which requires a diversion of resources and is not recorded in current productivity measures. Finally, the rapid expansion of the work force may have reduced the incentive for investments in plant and equipment, and increased the substitution of labor for capital.

IMPROVING U.S. PRODUCTIVITY

Continuation of poor economic performance by the United States economy has extremely important global economic and security

implications. So long as the United States economy suffers from inflation and reduced productivity growth, American industries will not be able to compete with their Japanese and other counterparts. We are concerned that unless the American economy is strong, the political will to support policies of broad partnership with Japan and other allies will be undermined.

There are other groups and institutions which are conducting comprehensive studies of the United States productivity problem and can address productivity issues in more detail. However, because of the importance of United States economic performance to United States-Japanese economic relations, we stress the following general points.

Improving the performance of the American economy and increasing productivity growth rates will require cooperative efforts by the American government and by the private sector.

The Role of the United States Government

(1) The President should make productivity a major focus of United States economic policy. We urge that a White House National Productivity Conference be convened to create greater public awareness of the need to stimulate productivity growth, identify reasons for poor United States productivity growth performance, and develop new policies and programs to reverse this trend.

(2) The Government should adopt policies which foster a non-inflationary, stable economic climate, conducive to investment and, thus, to improvements in productivity. High inflation and uncertainty about the future direction of the economy have been the major deterrents to the kinds of longer-term investments in new facilities, equipment, and technology that will improve productivity. Much of current United States inflation is not due to oil price increases, but is directly attributable to government policies such as many years of large budget deficits, excessive taxes, import restrictions for some industries, and burdensome and costly regulations.

(3) The President and the Congress should develop specific longer-term programs to increase supply-side determinants of economic performance such as savings and investment rates. The tax system should be restructured to provide greater incentives for savings and investment relative to consumption. It is essential that the heavy

burden of personal and corporate tax rates be reduced over time in a non-inflationary manner. Investment incentives for industry should be enhanced by shortening depreciation schedules and indexing them to reflect replacement costs. Double taxation of dividends should be eliminated. Investment tax credits should be increased and expanded.

Increasing the real rate of return on savings is essential to stimulate higher household savings in the United States. The recent phased deregulation of interest rates on passbook deposits, lower capital gains tax rates, and increased opportunities for tax deferrals for individuals will help. It is essential, however, to develop fiscal and monetary policies to bring inflation under control.

(4) The President and the Congress must develop new programs to encourage increased spending on research and development and to stimulate innovation.

The Group believes that tax incentives and other generalized programs to stimulate innovation and research and development are preferable to selective government support, although such support may be necessary in certain defense-related fields or where the scale is too large, the risks too high, or the payback too distant for private industry to undertake the necessary research and development entirely on its own.

We recommend additional tax incentives for private sector research and development (such as those already existing in Japan) and new measures to enhance the attractiveness of cooperation in basic research between private corporations and academic institutions. There should also be improved tax treatment for venture capital used for commercial innovation, especially in the case of smaller firms.

(5) The American government should reduce the regulatory burden on American industry and improve the equity and predictability of the administration of existing regulation. Cost analyses suggest that the cost of implementation of some regulations is disproportionate to their benefit. The impact on productivity should be an important consideration in the formulation and implementation of government regulations.

In some instances, regulations based on design rather than setting performance standards have impaired their effectiveness and raised the costs of compliance. Uncertainty in the way regulations may be implemented also often adds to the costs for private industry and discourages investment and innovation.

(6) The United States government should sponsor a comprehensive research program to determine what micro- and macroeconomic measures Japan and other foreign countries have taken in the public and private sectors to increase productivity and explore how these experiences can be effectively used in the United States. The continued high productivity growth rate in Japan indicates that management, labor, and government policies and practices in that country may provide lessons for the United States.

The Role of the Private Sector

The Group believes that given the proper economic environment, it is the primary responsibility of the private sector in both countries to improve productivity performance. In this regard, we applaud the initiative of the private sector in the United States in establishing the American Productivity Center as a focal point for research and the exchange of information on productivity problems in the United States. We also applaud other efforts in the private sectors and academic institutions of both countries to promote research, education, and innovation leading to productivity improvements.

(1) We believe that American corporate management should make productivity a principal responsibility of corporate leaders and a major test of their competence. Productivity considerations should be built into corporate objectives and be reflected in management attitudes. Management compensation plans should take into account the productivity performance of companies and managers. Compensation plans should reflect a long-term perspective rather than rewarding performance based on short-range financial results.

(2) Management and labor must work cooperatively to identify the reasons for poor United States productivity performance and develop joint programs for improvements.

We encourage consultations among labor, management, and outside experts on productivity trends, problems, and opportunities. These consultations should help speed the dissemination of proven "best practices," such as management-labor councils and quality circles.

(3) Much of the success of Japanese industry in improving productivity is due to the relationship between employers and employees. This is reflected in job security and a joint sharing of responsibility for the success of companies. While some American

companies pursue similar practices with success, there are things American management can learn from Japanese management techniques in personnel relationships. This is a place where American industry may have an opportunity for innovation.

Corporate leaders in the United States and Japan should establish joint programs to enhance productivity and increase bilateral understanding of such shared programs in productivity improvements and business management. We believe the private sectors should develop vigorous bilateral programs drawing upon each other's experiences. Both have much to gain since Japan has maintained the world's highest productivity growth rate while the United States has the highest level of aggregate productivity.

CHAPTER V

Japan's Market: Open or Closed?**IS JAPAN'S MARKET CLOSED?**

All national markets are to some degree "closed." The real question, therefore, is whether or not the Japanese market is more closed than the markets of the United States and other advanced countries. In this chapter, we will be discussing only the market for manufactured products. Japan's agricultural sector is certainly more protected than that of the United States, a subject which is more fully addressed in Chapter VII.

It is impossible to measure precisely how "open" any nation's market is. One needs to look at such diverse factors as the formal structure of tariffs and quotas, less formal official measures such as the practical administration of standards, customs, procedures, and investment approvals as well as intangible national cultural attitudes toward foreign trade. We have concluded that in terms of average tariff levels and quotas on manufactured products, Japan's market at the end of the phasing in of current tariff reductions will be no more closed than that of the United States. Indeed, given informal U.S. "quotas" in the form of orderly marketing arrangements, Japan's market may well be less closed. In terms of government procurement, standards, inspections and testing requirements, and foreign investment and service sector restrictions, Japan has made substantial progress in removing barriers, but more needs to be done to make its market as open to imports of products, services and capital as that of the United States. Other factors, such as administrative procedures, regulatory requirements, business practices, and cultural and social barriers, are very difficult to compare. It is our judgment, however, that these informal barriers make it especially difficult for foreigners to fully penetrate Japanese business and society,

In sum, the Group believes that Japan is not yet as "open" as the United States to foreign imports, capital, and influences. On the other hand, Japan appears to be generally meeting its international obligations to provide equal national treatment in those areas where there are treaties or international trade codes, and in this sense, Japan is playing according to the rules. The Group strongly believes, however, that in its own national interests and in the interests of a more harmonious American-Japanese economic relationship, Japan should strive to substantially improve access to its market and society and publicize this. The United States and Japan should provide international leadership in

There is a pervasive perception in the United States that Japan's market is more closed than those of other advanced countries, and particularly the American market. This perception contributes to a strongly negative image of Japan as a country which does not play the international trade game fairly, and it provides ammunition for those in the United States who advocate restrictive trade measures against Japan.

In Japan, the dominant perception is that Japan's market for manufactured products is as open as any in the world, and the American businessmen have not fully utilized the market opportunities available. Moreover, it is widely believed that while Japan has been liberalizing market access very rapidly, there are growing signs of protectionism in the United States and elsewhere, reflected in growing demands on Japan to accept temporary export restraint and other restrictions. This perception contributes to a negative image of the United States as a country which has allowed its own economy to become weak and is using Japan as a scapegoat.

These perceptions, and whatever realities lie behind them, represent very serious problems in American-Japanese relations. They lead to strong resentments, often bitterly expressed in the political arena and widely reported in the media, affecting other aspects of the relationship.

The Group, therefore, believed it essential to examine the facts about the Japanese market and the American economy. In the previous chapter, we looked at the question of whether or not the American economy was performing adequately; in this chapter we are concerned with the question of whether or not the Japanese market is as open as it should be.

setting an example and in strengthening the institutions and practices supporting freer flows of trade, capital, technology, human resources, and cultural and social influences. Both societies have a great deal to gain.

THE LEGACY OF PAST PROTECTIONISM

In the early postwar period, the Japanese market was highly protected. All international trade in goods and all foreign exchange transactions were carefully monitored and regulated. Import licenses were required, even for raw materials. All foreign investment and foreign exchange transactions required prior approval.

Beginning in the early 1960s, however, and continuing to this day, there has been an extensive liberalization of tariffs, quota restrictions, and capital restrictions both as a result of unilateral Japanese measures and Japan's assumption of broader international obligations upon joining such institutions as the GATT, IMF, and OECD. This liberalization process is described in a paper in the appendix.

Trade liberalization was often politically painful for the Japanese, while seeming painfully slow to non-Japanese. Viewed in terms of other economies, Japan's liberalization has occurred in a relatively short period, but viewed in terms of Japan's economic expansion, it was tardy. Moreover, the protectionism of the earlier period has left important legacies, both in foreign perceptions of the Japanese market by those whose experiences with Japan were formed in the earlier period and in Japanese bureaucratic orientations and regulatory and administrative survivals of the earlier era which still inhibit market access. We will examine a number of controversial elements and recommend steps needed to root out the remaining elements of Japan's protectionist past.

TARIFFS AND QUOTAS

Japan's remaining tariff and quota barriers to trade in manufactures are comparable to those of other developed countries. Significant tariff reductions were agreed to during the Tokyo Round of Multilateral Trade Negotiations, amounting to cuts of almost 60 percent on a

trade-weighted basis on industrial products of interest to the United States. As a result of Japan's tariff reduction commitments, its average tariff level on GATT-bound industrial products (on a trade-weighted basis) will be only 3.2 percent by the end of the eight-year period for phasing in MTN-agreed-to tariff cuts. Whether GATT-bound or applied duty rates are used as the basis of calculation, Japan's average tariff levels on industrial products will be lower than U.S. tariff levels on comparable products by the end of the implementation of the GATT Tokyo Round reductions in 1987.

As for quotas, Japan now has quotas for only five manufactured products, the most significant being leather goods. As in the case of the American market, formal industrial quotas are not an important barrier to access to the Japanese market for manufactures. Indeed, because Japan has agreed to orderly marketing agreements on voluntary restraints on some of its exports to Western Europe and the United States, it now is far more the victim of other countries' formal and informal quotas than a perpetrator of quota restrictions in international trade in manufactured goods.

We believe that both Japan and the United States should continue their long-term efforts to reduce tariffs and quantitative restrictions on the basis of reciprocity and most favored nation treatment.

FOREIGN EXCHANGE CONTROLS AND FOREIGN INVESTMENT

The level of American and other foreign investment in Japan is relatively low compared to foreign investment in other advanced countries. In fact, companies with 25 percent or more foreign-owned equity account for only 4 percent of total Japanese manufacturing sales and only 2 percent of total business sales.

Generally, the preferred vehicle for foreign direct investment in most countries has been the wholly-owned subsidiary; this in fact is the principal means by which American firms have entered foreign markets and Japanese and European firms have entered the American market.

In Japan, however, government restrictions throughout most of the postwar decades severely discouraged foreign businesses from establishing wholly-owned subsidiaries and limited their participation in the Japanese market to minority joint ventures, sales through trading com-

panies, or technology licensing agreement with Japanese firms. As a result, foreign ownership of business firms in Japan remains limited.

We note, however, that as in the case of tariffs and quotas, Japan has taken significant steps in formally liberalizing foreign exchange and investment controls. Over the past decade many legal barriers to foreign investment have been dismantled. Wholly-owned subsidiaries are not allowed in all but a few sectors such as mining, agriculture, and fisheries. Effective December 1, 1980, the restrictive Foreign Investment Law of 1950 was repealed and a new and more liberal Foreign Exchange and Foreign Trade Control Law and implementing regulations went into effect. This law is based on the general principle that external transactions, including foreign direct investment, should be free of control, except in the case of emergencies and special exceptions. This reverses the basic concept behind the previous Foreign Investment and Foreign Exchange Laws – that, in general, transactions should be restricted except where permission was granted.

Even under the new law, however, various controls remain in place or could be reinvented. Prior notice of direct investment in Japan above a certain percentage of shares is still required, and governmental authorities may still block transactions by refusing to accept notification. Where proposed direct investments are deemed to endanger national security or national order, are judged to do serious damage to Japanese business in the industry where the investment is planned, or have a serious adverse impact on the management of Japan's national economy, the Foreign Exchange Council established by the government may require changes in or disapprove the investment. Moreover, foreign investment is closely monitored and unfriendly acquisitions of existing Japanese firms by foreign investors ("takeovers") remain virtually impossible. It should be noted, however, that takeovers as a means of corporate expansion are relatively rare in Japan, even among wholly domestic firms.

Under the new law, bank borrowings by foreign interests and short-term overseas lending are generally permitted. So too are portfolio investment, the issuance of bonds, and the acquisition of real estate in Japan by non-residents. Prior notice, however, is required in many cases.

The new law and the related orders and regulations only set the basic policy directives. Actual implementation of the new system will determine how much liberalization has actually been achieved. We ap-

plaud the basic thrust of the Foreign Exchange and Foreign Trade Control Law, and we strongly recommend that it be implemented by the Japanese government in ways fully consonant with the principle of freeing foreign transactions from restraint. Exceptions under the law should be confined to genuine emergency situations. Moreover, we hope that the revised law will encourage further steps toward the freeing of interest rates and the encouragement of competition among financial institutions. This is desirable for a more efficient and internationally acceptable financial system. We believe Japan should continue to liberalize its foreign exchange and investment practices.

STANDARDS, INSPECTIONS, AND APPROVAL PROCEDURES

Like other industrialized countries, Japan has established an array of health, safety, environmental, and other standards as well as testing, certification, and licensing procedures to accompany them. The background paper, contained in the appendix, notes at least twenty-three laws and regulations in Japan regarding various standards which could affect imports. This has added another layer of bureaucratic hurdles to those which foreign producers must surmount in order to market their products in Japan. While there is a legitimate national interest in health, safety, environmental, and industrial standards, the administration of standards, testing, certification, inspection, approval, and registration requirements may implicitly discriminate against new or foreign competitors.

For example, until recently a foreign manufacturer could not apply directly to the appropriate Japanese agency for testing and approval; instead, he needed to apply through a Japanese importer who might not be familiar with the technical aspects of the product. Product testing for the sale of electrical equipment in Japan has been required to be performed in Japan, while the principal American testing company, Underwriters' Laboratory, maintains testing facilities in Japan for Japanese products to be exported to the United States. Another illustrative problem was the unavailability of Japanese Industrial Standards marks (JIS marks) for products manufactured abroad. Although JIS marks are entirely voluntary and not required by law, in practice many government agencies regard them as mandatory for procurement and

regulatory compliance. Since March 1980, foreign manufacturers have been permitted to apply for JIS marks.

Very substantial recent progress has been made in the area of standards promulgation, testing, and approval procedures. Both Japan and the United States signed the Standards Code negotiated at the MTN, providing for greater public visibility of governmental procedures for establishing and modifying standards. In addition, the United States and Japan reached in 1979 a bilateral standards agreement to address specific bilateral problems. The agreement provides for arrangements for acceptance of foreign test data in selected product such as electric appliances and some agricultural chemicals. The regulations on stability tests for new drugs were revised in April 1980 to allow acceptance of foreign test data, and foreign test data for animal vaccinations have also been accepted.

Foreign representation in Japanese government, industry, and joint institutions which develop, modify, and administer standards presents a problem in some industries. Japanese authorities appear ready to extend foreign access to standard setting procedures, testing, and certification processes. On some standards setting bodies like the Joint Industry-Government Electrical Standards Committee, foreign participation has recently been permitted.

Another recurring problem has been that Japanese standards have been based on design rather than performance criteria. A foreign product may not be approved for importation due to a difference in design even though it may have performance characteristics similar or superior to approved Japanese products.

Finally, the lack of effective appeals procedures under Japanese law serves to discriminate against new or foreign competitors and products. The more decentralized discretionary nature of the Japanese bureaucracy makes foreign firms fear that formal appeals will be ineffective and potentially counterproductive. Both the Japanese government and the American business community should make efforts to improve the workings of these procedures.

We applaud the recent bilateral and multilateral standards agreements and urge Japan and the United States to continue to reduce barriers to trade in the administration of health, safety, environmental, and industrial standards.

CUSTOMS VALUATION AND CLASSIFICATION

Foreign producers have long complained about Japanese customs valuation and classification procedures. One recurrent problem has been the use of "customs uplift" by Japan, raising the import valuation for tariffs and making the customs cost higher and more unpredictable for the foreign producer. Another problem has been the instances of arbitrariness and inconsistency in customs classification. Interpretations may vary by port, and decisions made by local customs officials are difficult to appeal. Although an appeals procedure does exist, foreigners are afraid to use it for fear of reprisals by the local officials.

Many of the customs problems appear to have been or are being addressed. The new GATT code on customs valuation establishes a uniform procedure based on transaction value and should minimize the application of uplifts. The Ministry of Finance in July 1980 established Customs Counselors in chief ports to give advice on problems of tariff classification, valuation, reduction, and exemption from customs duties. We applaud this step and hope Japan will continue to monitor potential customs problems.

ADMINISTRATIVE GUIDANCE

One of the most difficult aspects of the Japanese economic system for non-Japanese to understand is the nature of the government-business relationship. The more embracing set of consultations between the private and public sectors and less of an adversary relationship than in the United States lend substance in some American eyes to the concept of a "Japan, Inc." This image presents a very false and misleading impression of the Japanese economy. It is also very harmful to United States-Japan economic relations because it creates the false impression that Japan can manipulate exports and imports at will. Business does not meekly respond to government fiat nor is government the creature of business.

Most Japanese, however, do acknowledge the existence of government reliance on administrative guidance, usually describing the informal means by which the government attempts to influence business without resorting to legislative or regulatory measures as would be the case in the United States. While administrative guidance is part of the

fabric of Japanese government-industry relationships, some Japanese contend that it has become less effective. Business, they contend, ignores administrative guidance except when it is in an industry's or firm's interest. The Japanese government has few effective incentives or disincentives to enforce compliance on domestically and internationally competitive industries.

How administrative guidance affects foreign trade is not clear. In recent years, there has been little evidence of government pressures to restrain imports. Much more prevalent have been government efforts to restrain exports, as in the case of Japanese automobile exports to the United States. In this case, the industry has apparently paid little attention to the government.

Administrative guidance often serves a legitimate function in the Japanese economy, and its constructive use should not be condemned. What is important in the context of American-Japanese relations is that it should not be used in ways that discriminate against foreign interests. We believe that when administrative guidance is exercised, it should be exercised in a publicly visible, transparent fashion, and the rationale should be explained, even *post facto*.

ANTI-COMPETITIVE BEHAVIOR

"Administrative guidance" has sometimes been used by Japanese industry as a rationale for anti-competitive business practices which could affect imports and is certainly harmful to the interests of consumers. In a recent case involving price fixing by an illegal petroleum cartel, the industry claimed that their behavior had been suggested by MITI, an argument the government denied. This particular case is being addressed in the courts.

The Fair Trade Commission has statutory authority to investigate allegations of violations of Japan's anti-monopoly act. The Fair Trade Commission is gradually playing a stronger and more aggressive role in carrying out its function. **The Group strongly applauds the work of the Fair Trade Commission and hope that it will vigorously defend competitive business and international trade principles in Japan.**

GOVERNMENT PROCUREMENT

Japan, like European countries, has had virtually no history of government procurement by competitive bidding. The Government Procurement Code, agreed upon during the MTN, requires such a system. This is a revolutionary change for Japan, and there is a great deal of domestic opposition to the new code. At present, the major issue is the coverage of procurement by governmental "public policy companies," such as the Japan Tobacco and Salt Public Corporation, and Nippon Telegraph and Telephone (NTT). Nippon Telegraph and Telephone, which operates under the nominal supervision of the Ministry of Posts and Telecommunications, is a quasi-governmental organization with a statutory monopoly on domestic communications services and communications equipment procurement. Foreign and Japanese firms have been excluded from the Japanese telecommunications market as a result of single tender procurement practices which link product development with product procurement. Only four NTT affiliated "family" companies are authorized to participate in product development, and therefore, procurement contracts.

It is not our function to suggest specific solutions to such current trade disputes, such as those involving the NTT. We believe, however, that in keeping with the principles of freer international trade, the MTN procurement code should be implemented by both parties and that coverage of the code should be increased with successive renegotiations.

DISTRIBUTION SYSTEM

The complex and often seemingly inefficient Japanese distribution system appears to inhibit foreign access to the market place.

Although distribution channels in Japan vary according to industry, product-type, and characteristics of the final retail outlets, in general they involve many more layers of wholesalers than in the United States. The predominant pattern for apparel, furniture, stationery, and sundry goods, for example, involves passing the goods from producer to primary wholesaler to secondary wholesalers to retail outlets, and finally to consumers. Such a complicated network is necessary in these industries because of the large number of competing producers, the retailers' consequent need to stock a wide variety of merchandise lines,

and the small size of most retail outlets. In Japan, about 85 percent of retail establishments have less than four employees; the comparable figure in the United States is 65 percent.

A simpler pattern of distribution has now developed for handling many categories of consumer goods. This pattern, whereby large primary wholesalers purchase directly from producers and channel goods directly to retail outlets without participation of secondary wholesalers, is the predominant purchasing method used by large-scale retail stores. It is also prevalent in the home electric appliances industry where production is dominated by a few large-scale manufacturers.

There is a trend in some industries for producers to supply retailers directly, such as in the automobile industry. This pattern, however, is typical of only a very small part of the Japanese economy.

Japan's economy will be dominated by small producers and small-scale retailers for some time to come. Given this structure, the use of intermediaries is inevitable. Wholesalers make available to the small-scale retailers a broad selection of products the retailer could never identify himself; they play a major role in transportation, storage, dividing shipments, and packaging; and they often provide financing.

The distribution system is a fact of economic life in Japan, which discriminates against new market entrants both foreign and domestic. Yet, some non-Japanese companies have applied their expertise in exploiting the inherent inefficiencies of this system and have done well in marketing their products in Japan. We believe that although the Japanese distribution system is complicated, the exporter willing to patiently study the system, carefully select the best channel for his products, and spend the money necessary to develop the market, can effectively and profitably market his products through the Japanese distribution system.

BUSINESS PRACTICES

In the private sector, there are significant differences in the nature of commercial relations in Japan and the United States. Japanese commercial relations depend on a number of long-term, non-quantifiable, and often personal variables. American commercial relations, on the other hand, stress more immediate and quantifiable price and cost

considerations. In Japan, commercial disputes are typically resolved by negotiation and compromise rather than through the use of legal documents, lawyers, and courts.

Japanese corporate group or *keiretsu* procurement practices are often regarded as a considerable obstacle to foreign marketing strategies. The stringent quality and after-sales service demands of Japanese consumers also tend to favor domestic suppliers more accustomed to providing such services as a normal part of a transaction.

In this context, it is important that exporters to Japan understand and try to use to their advantage Japanese business practices.

For instance, Japanese firms have a strong preference of developing long-term, stable business relationships rather than engaging in spot transactions using whomever happens to be the lowest cost supplier at the time. After-sales service is an important part of this strategy. Among Japanese companies the period and scope of after-sales service is seldom precisely defined in contract provisions. Rather, it is understood in an all-embracing sense. In contrast, in the United States, the terms for after-sales service — the extent of the supplier's responsibility for stocking spare parts, holding periodic inspections, granting technical services, and the like — must be clearly set down in the written contract.

In Japan, socializing and maintaining close personal relationships among business partners are important for succeeding in business in the long-run. Even in making the initial approach, it is advisable that the initial contact be made by a suitable third party. In starting negotiations, a personal visit to the Japanese enterprise is preferred over sending a business letter. As Japanese enterprises usually make decisions by group consensus, it is necessary to proceed step by step, moving up through the hierarchy of the company structure.

SOCIAL AND CULTURAL FACTORS

Despite all that has been done and can be done by law and policy to open the Japanese market, Japanese culture presents many difficult barriers to foreign penetration. As an island country closed to the world for several centuries, Japan entered the modern era a highly homogeneous society. It had a unique culture that the Japanese people properly have been determined to preserve. Despite Japan's assimilation of Western technology and culture, the Japanese have succeeded

to a remarkable degree in maintaining their own values and forms of social intercourse. With these, they have also maintained a sense of uniqueness and separateness.

This sense of separateness, which has been reinforced by Western prejudice and discrimination against Japanese, has made it difficult for the Japanese to fully participate in the international community, in spite of the high degree of interdependence linking Japan economically and politically with other countries. While foreigners are treated as honorable guests in Japan, they remain guests no matter how long they stay. This is reflected in Japan's overly complicated immigration and visa laws and procedures.

The difficulty of the Japanese language for non-Japanese to learn undoubtedly also contributes to foreign perceptions of Japan as a closed society. With the Japanese language's unique structural characteristics, its complex writing system (which includes the use of Chinese characters and two separate phonetic syllabaries), its rich vocabulary and subtle forms of expression, not many Westerners have achieved working fluency in Japanese and only a handful can be said to have "mastered" it. Although the Japanese are hardly to be blamed for the complexity of their language or the failure of the foreign businessmen to devote enough time to its study, its difficulty contributes to a general sense of Japanese society as closed and impenetrable.

We believe that while it is the primary responsibility of those who want to work in Japan to accommodate to the Japanese culture and society, the Japanese government should encourage greater communication and social interaction with the international community. We have made a number of recommendations along this line in Chapter I.

OPENING THE JAPANESE MARKET

Twenty years ago, the American market was already substantially open. Japan's market was very closed, the consequence of wartime policies and postwar economic weakness. Since that time, Japan has made some substantial progress in liberalizing market access, although as our survey has shown, much more needs to be done if Japan is truly to exercise leadership on behalf of an open world trading system. Progress will take time, especially when it comes to those business practices and cultural traits which are deeply imbedded in Japanese

society. Just as the United States cannot legislate "export consciousness," Japan cannot legislate "import consciousness."

The Group, however, believes that there are measures which Japan can take to further open its market and to remove real and symbolic trade irritants. We also believe that there are measures which the American government and business community should take to improve American access to the Japanese market.

The Creation of an Office of Trade Ombudsman

A major problem of Japanese trade policy has been those bureaucratic attitudes, practices, and regulations inherited from an earlier protectionist era. While some of Japan's government ministries have become sensitive to broader international trade policy issues, others are much more domestically oriented and are reluctant to consider the international impact of their decisions or review the special problems of foreign importers. The decentralized and discretionary nature of the Japanese government compounds this problem. Often there are no clear higher channels of appeal, or foreign businesses do not exercise appeal rights, fearing retribution.

Bureaucratic rigidities should not be an obstacle to trade with Japan. We believe it essential that some Japanese ministries traditionally more oriented toward domestic considerations take greater cognizance of the international consequences of their decisions. Japan could address trade import problems more effectively if appropriate governmental institutions were created to help resolve interagency conflict. These institutions would also be symbolic of Japan's commitment to an open market and open world trading system.

We, therefore, urge the Prime Minister of Japan to establish a powerful central office for the consideration and resolution of trade problems. This office should act as a government-wide ombudsman for trade and investment issues. Governmental regulations having trade significance administered by domestically oriented ministries could be reviewed by the office. It is important that the office not be attached to a single ministry, and that it has power to intervene in administrative processes. It should be staffed with highly qualified individuals with technical expertise and experience in other governmental ministries.

We believe that this office should deal with broader policy issues as well as with company-specific complaints regarding market access to Japan.

In 1977, the Trade Facilitation Committee (TFC) was established to provide for the resolution of company-specific complaints. While generally successful, this mechanism is limited by being attached to a single Japanese ministry — MITI. It also lacked jurisdiction over trade problems in other ministries and service sector issues, an area we believe will become much more important in United States-Japan economic relations.

By referring company-specific complaints to the central office we have recommended be created, such complaints can be considered across a broader spectrum of issues, at a higher level, and with reference to any ministry.

Support for the Trade Study Group

The Trade Study Group (TSG) was organized in 1977 on a volunteer basis by American and Japanese business representatives and government officials. The TSG has served a number of very important functions. It has established working committees and task forces which have identified and analyzed foreign business complaints and brought them to the attention of Japanese government officials. It has provided a forum for direct contacts between American businessmen and Japanese officials, helping to increase understanding on both sides. It has also encouraged American business efforts to improve market access in Japan through specific trade promotion program. As a result of the TSG, testing and certification procedures for electric appliances have been liberalized.

We applaud the work of the Trade Study Group and believe that the two governments should give it their full support, including financial assistance, to make its operations even more effective.

Improve Transparency and Openness of Governmental Economic Decision-Making Processes

In comparison with the American governmental decision-making process, that of the Japanese government remains much more opaque. Such concepts as public hearing procedures, public comment on governmental regulations prior to their promulgation, public right to information, due process, and appellate review do not play as great a role. This system often discriminates against foreigners, and also Japanese not in

the traditional information network.

As the result of Japan's international obligations, including the new MTN codes, Japanese decision-making in some areas will become more accessible to the public, including foreigners. We urge Japan to continue to expand the public visibility of its governmental economic decision-making and implementing processes and to provide for additional opportunities for access to these processes by the private sector.

More Strenuous American Business Effort to Expand Access to Japanese Bureaucracy

Japanese business, sometimes with governmental support, has engaged in extensive activity in the United States to promote its interests. This activity includes the sponsoring of research and seminars, testifying before Congress and other governmental bodies, attending hearings and press conferences, and public relations efforts. There are fewer institutions available for such activities in Japan. Moreover, the American business community has not been as active as it could be in seeking direct or indirect access to Japanese bureaucratic and political institutions. A more open Japanese economy requires not only steps by Japan to provide easier access, but also by non-Japanese to take advantage of the opportunities provided. American businessmen might consider the creation of an organization similar to the United States-Japan Trade Council in Washington and representation in Japanese industry associations. We urge Japanese industry associations to welcome foreign participation.

Finally, it should be noted that liberalization of the Japanese economy remains politically difficult for the Japanese government. Japan's ability to continue to liberalize will be influenced by the ability of other advanced countries, especially the United States, to maintain free trading policies. We have noted a disturbing trend in the United States and Western Europe of growing protectionist pressures, reflected in requests to Japan to exercise temporary export restraints while domestic industries elsewhere "adjust." Growing protectionism among Japan's trading partners undermines the political effectiveness of those in Japan who support freer trade and a more open Japanese market.

Industrial Trade Issues

Many of the most controversial issues in recent American-Japanese economic relations have centered around competition in specific industries, such as textiles, steel, color televisions, and autos. These issues reflect intensified international competition and relatively rapid shifts in the structure of competitive positions. Low tariff and trade barriers as well as modern communications and marketing systems assure that consumers become aware of products on a worldwide basis so that changes in comparative advantage will soon be reflected in trade flows. This is a general change, and it is true of not just Japanese-American relations. It is welcome because it increases economic efficiency and has substantially benefitted both the American and Japanese economies in overall terms. Yet it also places tremendous adjustment pressures on particular industries.

What are the factors behind national differences in comparative advantage? The basic determinants are such factors as a nation's endowment of raw materials, capital, technology, and labor resources. As we have explained in Chapter II, such basic structural factors play a strong role in influencing the kind of products traded between the United States and Japan, with American merchandise exports more diversified among agricultural products, raw materials, and manufactured goods, whereas Japanese exports are concentrated in manufactured goods.

The structure of comparative advantage also reflects differences in government policies. Macroeconomic policies which influence the general investment climate and policies towards a particular industry can be important factors in determining relative competitive positions and,

therefore, trade patterns.

Finally, corporate organization and strategy are also significant in determining shifts in competitive positions of individual industries. A firm's capacity to compete in the world marketplace is also influenced by its own management decisions, although these are also shaped by more general public policies and economic conditions.

The Group examines three industries — steel, automobiles, and semiconductors — where there have been significant trade issues between the two countries. Automobiles are currently the most significant trade problem between the United States and Japan; steel has been a recurring trade problem over the past decade; the semiconductor industry reflects differences in industry structure, capital markets, and government research and development policies which may cause trade problems in the future. From our study, we have derived some general public policy principles as well as more specific industrial recommendations designed to encourage mutually beneficial responses to industrial problems.

GENERAL PRINCIPLES

(1) Both governments should foster a stable non-inflationary economic climate which encourages economic growth and facilitates adjustment.

Both the United States and Japan have relied primarily on the private sector responding to market forces to achieve economic growth and development. A significant exception in the 1950s and 1960s for Japan, however, was the targeting of some "key" industries. In these decades the Japanese government, in consultation with industrial leaders, designated certain sectors as target industries to receive priority in allocation of foreign exchange, direct and indirect governmental loans and loan guarantees, and tax incentives. These target industries were also protected by trade barriers and restrictions on foreign investments, as were virtually all industries. Specific target industry measures involving trade and investment barriers as well as tax incentives and research and development aid were also used in the 1970s for promoting some high technology sectors. Although these policies were important, probably a more important factor in Japan's industrial growth was the highly competitive domestic market, encouraging firms to adopt more productive technologies and processes. Another major factor was that Japanese

firms were oriented towards exporting, forcing constant awareness of international competition when making pricing, product, and production decisions.

Although we do not recommend that the United States emulate specific Japanese policies and programs, we do believe that the American government should take steps to improve the overall climate for industry by such mechanisms as incentives for capital formation, support for research and development, export market development programs consistent with international rules, and regulatory reform. We believe that for the United States general measures to promote productivity, investment, and research and development are generally preferable to measures that provide for special tax treatment or government aid to specific targeted industries. We discuss some of these measures in more detail in Chapter IV.

We also see a need in the United States for closer collaboration between industry and the government in considering general economic conditions and assessing specific industry problems. We welcome the creation of the tripartite government-business-labor committees for automobiles and steel in the United States and believe such committees should be established in other industrial sectors, whether or not they are currently experiencing trade problems.

Japan's economic structure and policy-making framework has been oriented toward rapid economic growth. Slower domestic growth in Japan since the early 1970s has created serious adjustment problems. Since underlying conditions suggest that both the domestic economy and world trade will continue to grow at slower rates, the major challenge facing Japan will be to establish a new government-business consensus to achieve industrial adjustment under conditions of slower growth.

With respect to the American-Japanese relationship, slower domestic growth in Japan creates incentives for capital-intensive Japanese firms to seek to continue past rates of expansion through larger export markets. This indeed has been the experience of the Japanese automobile and steel industries, where continued high rates of growth in a saturated domestic market contributed to export expansion. Under present international conditions, however, further rapid export expansion is likely to be difficult.

It is essential, therefore, for the Japanese government to encourage domestic sources of growth as one important way of reducing the

potential of global trade frictions and of easing internal adjustment problems.

(2) Both governments should maintain policies promoting a world free trade and investment environment.

Trade restrictions do not promote industrial growth. Instead, they shield industries from international competition, weakening their incentives to adjust to this competition and expand export opportunities. It is in the national interest of both countries to promote rather than postpone the domestic economic changes necessary to meet global competition. Free trade and investment promote economic efficiency, help retard inflation, expand investment opportunities, and widen consumer choice.

We believe that both Japan and the United States should vigorously defend and abide by the international trading rules and bilateral accords. Remaining barriers to trade and investment in both Japan and the United States should continue to be removed. Mature economies are not justified in using trade barriers to protect either infant industries or older industries.

The Group recognizes that it is not politically realistic to expect some industries to face the full force of sudden foreign competition. Owners, workers, and communities will seek some form of import restraint. Protection, in the event of injurious and seriously disruptive trade flows, is permissible under GATT trade rules. Such protection, however, should be of limited duration, designed to facilitate rather than to impede adjustment processes. Both governments should recognize the inherent limitations and often significant costs of such protection. In view of the increasing requests by European countries and the United States for temporary restraints on Japan's exports for adjustment purposes, these governments should insure that the protected industries efficiently utilize any time provided for adjustment.

(3) Both governments should adhere to the principle of equal national treatment in programs relating to industry.

Formal trade and investment restrictions have largely been removed in Japan, the United States, and most other major trading countries. Except for politically sensitive sectors such as agriculture, steel, and textiles, further liberalization will result in only marginal changes in trade and investment patterns.

Discrimination against foreigners in domestic promotion policies may, however, become a major source of bilateral and global friction.

Foreign owned firms are not always accorded equal national treatment with domestic firms in participation in government programs to promote domestic industries.

Foreign owned firms in the countries should be treated equally with domestic firms. They should be permitted equal participation in tax incentives, grants, loans, guarantees, research and development programs, procurement contracts, and other forms of direct and indirect government support for domestic industries.

(4) There should be a clearer understanding in both countries of foreign industrial policies and specific industrial problems.

Many bilateral trade problems have arisen as a result of misperceptions and the unclear identification of the impact of industry promotion policies. Often American industry has complained of Japanese trade and investment restrictions or industrial assistance programs, when, in fact, these restrictions have been phased out or assistance programs ended. This has led to Japanese complaints that the U.S. industry and government do not adequately recognize the basic causes of Japan's international competitiveness. Similarly, in Japan there are misperceptions about some facets of American policies and practices, such as American trade laws and the economic problems of some American industries.

We believe such misperceptions could be substantially reduced by more frequent consultations by both the United States and Japanese governments and between government and the private sector in both countries.

The Group recommends that periodic bilateral discussions be held between the Japanese and the American governments on trade and investment restrictions liberalization programs and implementation procedures, and on industrial promotion policies. Such policies should be clearly identified in scope, magnitude, and duration to facilitate understanding.

We also recommend that there be enhanced bilateral business, labor, and government dialogues, consonant with the laws of each nation, to identify and discuss potential industrial sector problems before they become major economic and political disputes.

A change in bilateral and global trade patterns is likely to be reflected in trade statistics only at the final stage of a shift in comparative advantage and competitiveness. Government intervention is likely to be least effective and most counterproductive at this stage. Adjustment

is most likely to be successful when potential problems are recognized at an early stage.

(5) Both governments need to be more conscious of the international implications of domestic policies.

In an interdependent world, it is essential that considerations of international trade and competitiveness be kept in mind when domestic economic policies are being formulated. In the United States many policies which affect industrial structure and competitiveness reflect domestic political concerns. International trade has been traditionally of relatively low priority. As a result, the United States has adopted some policies and regulations which act as disincentives to export or injure the ability of American firms to remain competitive against foreign products in domestic markets. Recently, a number of Executive and Congressional reports have identified such measures, and we hope that corrective action will be taken. We strongly urge prompt implementation of the recommendations of the President's Export Council.

In Japan, on the other hand, general macroeconomic policies and industry-specific policies reflect a generally greater emphasis on the importance of international trade. This helped increase the global competitiveness of Japanese industry. Japan, however, has been slower to recognize the advantage of import and investment liberalization than of export promotion measures. We are encouraged by major advances in these areas in recent years, but believe more progress is needed. We discuss this subject in Chapter V.

(6) Corporations, especially in the United States, need to have a longer-term and more internationally oriented perspective.

There is no clearly identifiable "American" or "Japanese" corporate strategy. However, we have noted a difference in emphasis between the American corporate concern with current profitability and the longer-term Japanese perspective emphasizing corporate growth. This difference reflects national business practices in each country and, particularly, the requirements of raising capital. The American emphasis on quarterly and annual profit-and-loss statements tends to discourage longer-term investments and overseas market development programs which may return profits only many years after the initial investments. This, in turn, retards American competitiveness in overseas markets and, in the absence of market growth, may retard the adoption of modern technology.

Although there are many exceptions, another general difference is that Japanese corporations, like Japanese economic policies, tend to be more internationally oriented. Japan's highly successful international trading companies facilitate participation in foreign trade by small and medium-sized Japanese firms. Also these trading companies tend to promote exports of the other members of same industry group. In contrast, in the United States, generally only larger firms are active in international markets, and large-scale international trading corporations and corporate groupings do not exist.

We urge that American corporations adopt a longer-term perspective that will increase the competitiveness of American industry in domestic and international markets as well as facilitate adjustment in an era of rapidly changing competitive positions.

We applaud the stronger public and private efforts in the United States to encourage corporate awareness of overseas market opportunities. We also welcome Administration and Congressional support for legislation to encourage the establishment of larger-scale, better financed American trading corporations. We recommend that this legislation be enacted.

SPECIFIC INDUSTRY RECOMMENDATIONS

Steel

Steel is a major intermediate product. Protection of the American steel industry maintains inefficient mills, raises the costs of production of steel users such as the automobile industry, and thus fuels inflation and weakens the competitive position of other American industries. In the absence of protection, newer, more competitive plants would survive, strengthening the U.S. steel industry and permitting U.S. steel users to buy steel at world prices. This would place no additional burden on the American people as taxpayers through government subsidies or consumers through high prices.

We urge that in the long-run the United States adopt a policy of free trade in steel and that there be no industry-specific policies instituted to protect the American steel industry. Free trade policies need not condone dumping or illegal subsidies. The laws to counter such unfair trade practices should be vigorously enforced.

The U.S. steel industry needs to revitalize itself to become an efficient competitor. In the long-run the industry will benefit from the Group's policy recommendations for general improvements in incentives for capital formation, such as accelerated depreciation rates, investment tax credits, and support for research and development.

In addition the United States has recently reinstated the Trigger Price Mechanism for steel imports for a five-year period. This is one way to increase domestic steel industry profits for reinvestment purposes, though the Group notes the burden of higher steel prices borne by American users of steel. Direct government assistance to U.S. producers would be preferable as it would hold down steel costs for users. It would enable them to maintain a more competitive position against foreign competitors paying the world market price of steel. Moreover, such direct assistance would be easily identifiable, highlighting the costs of industry support to the American public.

The Group recommends that, if it be continued, the Trigger Price Mechanism be utilized for no longer than five years. During that time, the U.S. steel industry must be expected to become competitive.

We recognize that free trade in steel may result in a substantial rise in the share of imports. There would be an acute unemployment problem in the communities in which older plants are located. Even under a policy that attempted to maintain greater national self-sufficiency in steel, however, these plants would be subject to eventual replacement by new facilities, not necessarily in the same location.

We urge generous adjustment assistance to communities and workers unemployed because of adaptation of the steel industry to its changed international position.

There is a danger that the reduction of domestic steel capacity will fall disproportionately on defense-critical items (most of which come from the older plants), such as tank turrets, special weapons components, and tube production for large bore gun barrels. Explicit governmental assistance may be needed to build and maintain the productive capabilities required for these defense needs. However, these defense requirements need to be carefully defined and identified.

The Japanese steel industry is likely to face increasing competition from new capacity built in lower wage Asian countries. Japanese producers can maintain the competitive position of its current capacity by upgrading the quality of its product line and by cost-reducing innovations.

We recommend that Japan continue its free trade policies toward steel in the future, particularly in trade with the newly industrialized countries.

The problems of the steel industry are worldwide. While neither the steel industry in Japan nor in the United States is directly supported by the government, many other governments do subsidize or own steel plants. Both the United States and Japan may have to exercise their rights under GATT codes to effectively protect their steel industries from dumped or subsidized steel imports.

Automobiles

The domestic and international position of the U.S. auto industry has declined temporarily while the Japanese auto industry is becoming increasingly competitive in world markets, particularly in the U.S. market. This shift in competitive positions and trade patterns has led to critical problems for a major sector in the U.S. economy: high unemployment in the U.S. auto and related industries, and a severe impact on many American communities.

We anticipate that the U.S. automobile industry will be strongly competitive once the transition to small car capacity has been completed. During this transitional period, unemployment and adjustment assistance is necessary for workers in the automobile and related industries and for communities disproportionately impacted by this transition.

The Group believes quotas or other restrictions on U.S. imports of Japanese automobiles not to be in the interests of either the United States or Japan. Such restrictions would limit the choice of U.S. consumers, channel demand toward less energy-efficient vehicles, exacerbate U.S. inflation, while not effectively addressing either U.S. unemployment or capital formation problems.

The decision whether to manufacture automobiles in the United States should be left to Japanese producers and should be essentially a business decision, reflecting overall corporate strategy and marketing strategy, and taking into account the economic, social, and political environment in which firms regard it both natural and desirable to establish production facilities in important foreign markets through direct investments. To force investment in manufacturing facilities by non-economic factors is contrary to the concepts of trade liberal-

ization and international specialization, and could be a costly waste of resources.

Japanese government restrictions on imports and foreign investment in the auto industry are now minimal, although Japan was slow to lift these barriers. Recent bilateral negotiations have addressed the problems of the commodity tax differential between large and small cars, standards, testing, certification, and inspection procedures. Japan's tariff on automobiles has been reduced to zero. Further progress on auto part tariffs and on some of the above standards, testing, certification, and inspection issues is still needed, but the primary responsibility for expanding U.S. auto sales in Japan rests with U.S. manufacturers and their representatives in Japan.

Semiconductors

Private industry in the United States pioneered in the development of the semiconductor industry. Until recently the U.S. semiconductor industry enjoyed worldwide technical and market leadership, but Japanese semiconductor manufacturers are fast overtaking the lead enjoyed by U.S. manufacturers.

This industry and the related computer industry present a possible future source of trade friction between Japan and the United States, even though many of the issues between the two countries are on the way to resolution as trade and investment restrictions are lifted.

Semiconductor trade between the two countries is continuously growing as imported semiconductors complement the domestic production in each of the two countries. There have been an increasing number of Japanese semiconductor manufacturers who are locating their operations in the United States and U.S. manufacturers are likewise expanding their investments in Japan. Such cross-investment, based on normal commercial considerations, will no doubt reduce the potential of future trade conflicts. The substantial trade and investment liberalization measures recently implemented in Japan could benefit the American semiconductor manufacturers and may lead to further expansion of U.S. investment in Japan.

This trade and investment expansion attests to the critical importance of maintaining and strengthening a free and open trade and investment environment so as to guarantee the future growth of this industry on a worldwide basis.

In spite of these encouraging trends, there still exist some basic problems in the semiconductor industry. The very rapid rate of technological development in this industry requires substantial capital investments in research and development, production facilities, and equipment, which in turn requires that there be an investment climate that favors capital formation and rationalization of the industry in both countries.

In order to avoid potential trade and investment problems between Japan and the United States that might arise as a result of friction between the Japanese and U.S. semiconductor industry, the Group recommends the following:

(1) That the Japanese and U.S. tariff cuts agreed to in the MTN should be accelerated to arrive more promptly at the 4 ½ percent level. Both countries then should move as quickly as possible to reduce their tariffs to zero.

(2) That U.S. manufacturers in Japan and Japanese manufacturers in the United States be allowed by the respective governments to participate in government research and development and procurements on the basis of equal national treatment.

We note that our recommendations in Chapter IV, on productivity, would encourage competitive developments in the U.S. industry in general and in particular would benefit capital-intensive industries with rapid obsolescence of plant and equipment.

Agricultural Trade Issues

Mutually beneficial economic interdependence between Japan and the United States is nowhere more evident than in the area of agricultural trade. Japan is the world's largest importer of agricultural products, and the United States is Japan's foremost supplier, American foodstuffs accounting for a quarter of Japan's caloric intake. The United States is the world's largest exporter, and Japan has become its most important single customer, purchasing more than \$5 billion in agricultural goods in 1979. It has been estimated that one of every twenty acres cultivated in the United States produces food for Japan.

The transformation of Japan's food system is a major cause of the development of this symbiotic relationship in agricultural products. Thirty years ago, the Japanese diet reflected a traditional grain-based pattern of food consumption; now animal products account for approximately 20% of Japan's caloric intake, and this percentage will undoubtedly continue to climb. Given Japan's limited arable land, this dietary change has necessitated increased dependence on foreign imports, particularly of livestock feed. During the past two decades, Japan's dependence on food imports has increased from 20% to 50% of primary food energy consumed, with half coming from the United States. For feedgrains, the percentage of imports from the United States is much higher; the United States accounts for 95% of Japan's purchases of soybeans, 82% of its corn imports, 75% of its imports of soybean meal, and 59% of its wheat purchases.

Despite the highly complementary nature of the agricultural relationship, agricultural trade has at times been a source of serious economic friction. The intensely publicized United States-Japan

trade dispute of 1977 – 78 over the liberalization of Japanese beef and citrus quotas could have escalated into a bilateral crisis. It is obvious that Japanese agriculture is now, and will be for some time to come, the target for trade liberalization pressure as there are protectionist agricultural quotas and other measures protecting its domestic farm sector which deny full access to a market in which the United States is highly competitive.

We believe there are significant opportunities to further enhance mutually beneficial complementarity in the United States-Japan agricultural relationship. In this chapter, we will consider ways and means of so doing through the further opening of the Japanese market for American exports, the restructuring of the Japanese agriculture to develop a more efficient and internationally competitive farm sector, and the achieving of appropriate measures of food security.

THE HIGH COST OF AGRICULTURAL PROTECTIONISM

Japanese agricultural and marine product imports substantially increased during the period of high Japanese economic growth. From 1965 to 1979, imports of agricultural products alone increased three and a half times. During the same period, the number of agricultural and marine product items subject to import quotas decreased from 73 to 22. Also, the number of items under residual import restrictions has decreased from 103 agricultural items in 1962 to 17 presently. Thus, it can be said that Japan has substantially liberalized agricultural trade in the process of economic growth.

Nevertheless, the fact that Japan still retains agricultural quotas assure that agricultural trade will continue to be an issue in American-Japanese economic relations. While farmers in both countries receive protection against competitive foreign agricultural imports, Japan's level of protection is much higher and affects the bilateral economic relationship much more seriously. The fact that the price of rice paid to Japanese producers is about three times the world price is the most obvious measure of the extent of the Japanese government's agricultural protectionism.

This protectionism is very costly. It has been estimated that the resource cost of agricultural protectionism in Japan was \$15 billion in 1977 – 78, more than half of Japan's gross agricultural output. This

is not only expensive for Japanese consumers and taxpayers; it also hurts Japanese farmers by discouraging higher-productivity growth in the agricultural sector. There is ample evidence that Japan could be an efficient and competitive producer of a number of agricultural products, but a basic restructuring of its food policies are required. The fact is that Japan is now making a much greater effort to protect existing inefficient patterns of agricultural production rather than adjusting to a new, more competitive pattern. The immediate goal of policy should be the narrowing of the gap between world market prices and domestic agricultural prices.

Both governments, but especially Japan, should reduce protection of their farm sectors. In this respect, the shift in emphasis in Japan's food policy away from a particular percentage of self-sufficiency and toward more flexibility can be welcomed.

Agricultural protection in Japan reflects social welfare policies toward the farm sector and is sustained by the political influence wielded by a highly organized agricultural community. Clearly, a politically and economically viable policy of reducing import barriers to agricultural products must be accompanied by means of providing income stability for Japan's farmers.

We recommend that Japan continue its efforts to shift away from the use of quantitative restrictions on agricultural imports and to ultimately eliminate them by redirecting support policies so that international prices are more adequately reflected in determining the level of domestic price supports. Today, quota restrictions reflect domestic pricing considerations rather than the balance of payments necessity. However, quota restrictions permit much of the extra cost paid by the consumer to be reaped by the importer with a quota share, not by the farmer. In order to eliminate such quantitative restrictions, the Japanese government should make comprehensive study of protective measures, pricing policies, restructuring of agriculture, and other factors. Although the Japanese experience with deficiency payments on mild products and soybeans show that the deficiency payments system may not improve productivity in the Japanese context, it should be considered as one of the possible alternatives. The Japanese government needs to carefully study the economic and budgetary implications of the use of deficiency payments.

During the period that quota restrictions remain in use, the application of such restrictions should be predictable and information on

their operation should be available to the public.

RESTRUCTURING JAPANESE AGRICULTURE

If liberalization of agricultural imports is to mean a destruction of domestic agriculture in Japan, it will be resisted not only by the farmers, but by many other Japanese who value the contribution agriculture makes to society beyond its purely economic aspects. The only long-term answer is to make structural adjustments in agriculture that will foster a domestic farm sector efficient enough to compete against international competition. This restructuring will benefit Japanese farmers and consumers, and it will enhance trade relationships with the United States. We will consider several important areas where reforms are needed.

Land Tenure

Economies of scale are a key to improving agricultural productivity. In Japan, very small-scale farming operations make it impossible for Japanese farmers to achieve the economies of scale needed to be internationally competitive. The average size of agricultural operation per farm household is 1.1 hectare of arable land in Japan, compared to 4 hectares in Italy, 15 hectares in France, 26 hectares in Great Britain, and 69 hectares in the United States.

Only one of every eight Japanese farmers is full-time. Indeed, some 70 percent of Japanese farm families receive almost all their income from factory or other non-farm work. One reason for this is that current Japanese land tenure policies engender fears that leasing or leaving one's land is tantamount to losing it forever. Moreover, land rents are controlled at very low levels. For these reasons, there is little incentive for the large proportion of less efficient part-time farmers to rent their land to full-time farmers. The latter are largely denied the opportunity to expand the size of their operations.

The Japanese government has begun to grapple with these problems. We recommend that as part of a policy of developing a more productive and competitive agricultural sector, Japan should further encourage a land rental market to help increase the average farm size. Landowners need assurances that they will not lose their right to own

land by renting it to full-time farmers.

Rice Policy

Despite steadily decreasing consumption of rice in Japan, Japan produces a surplus of rice at prices about three times the world market price. This policy has led to mounting surpluses. In 1979, Japan began to dispose of these surpluses through exports, and this, in turn, created trade problems with major rice exporting nations, including the United States.

Japan's rice policy has other negative features. Professor Yujiro Hayami points out in a paper summarized in the appendix that the high level of rice price supports is the main obstacle to the restructuring of Japanese agriculture. The price support program has absorbed a high proportion of the government's agricultural budget which should instead be devoted to agricultural adjustment. It encourages the continuation of inefficient part-time farming. It uses land which could be more productively devoted to forage, increasing Japan's ability to develop an internationally competitive livestock industry.

Government price supports should not encourage the production of commodities whose prices are already much higher than the world market price. We recommend that Japan make stronger efforts to hold down the production and price of rice.

Citrus Fruits and Beef

In the United States, Japanese quotas on citrus fruits and beef have become symbolic of Japanese agricultural protectionism. These quotas are being gradually expanded, but they are likely to become an issue again in United States-Japan economic relations unless there is a more fundamental change in Japanese policy. This is true even though market projections suggest that if quotas were lifted completely, United States export of these commodities would still be relatively modest compared to the very large export of soybeans and grains to Japan. Agricultural experts in both countries believe that Japan could develop internationally competitive citrus and beef industries. Protectionism, however, discourages rationalization of these industries and tends to preserve inefficient production methods. Moreover, because of high consumer prices, it discourages domestic market

expansion.

Alternatives should be found to the total dependency of farm income stability for citrus fruits and beef import quotas and domestic price support policy. Japan should accelerate means of increasing the efficiency of its domestic citrus fruit and livestock industries. Aside from the land tenure policy changes, there should be more intense research, extension, and market analysis and development programs.

Japan's fear of food shortages, particularly after the world food crisis in 1973, is probably the most difficult aspect of Japan's food policies for Americans to fully appreciate. Since the war, one of the foremost concerns of the Japanese government, regardless of who was in power, has been that of assuring a dependable supply of food and especially of the principal grains through the promotion of domestic agricultural production. The memory of acute shortages of food during and immediately after the war is still very much with most of the adult population in Japan.

Accompanying the dramatic increase in agricultural imports over the years has been a substantial decline in Japan's self-sufficiency in foodstuffs, creating apprehension among the Japanese people. Although self-sufficiency and even surpluses are maintained for rice, the ratio of self-sufficiency for all cereals is less than 40 percent, the lowest of any major industrialized country.

The impact of the United States' unilateral embargo of soybeans in 1973 must be understood in this context. The continuing threat of shortage in petroleum supplies has also helped to keep alive the fear of a comparable food crisis in Japan.

The United States must be cognizant of the extreme sensitivity of the question of food dependency and security of food supplies in Japan. To provide for a better political environment for the reduction of Japanese barriers to agricultural trade, there must be much stronger assurances of food security. On the other hand, it is unrealistic for Japan to substantially increase its level of self-sufficiency of food. Food security cannot be guaranteed through continued high protection of inefficient agriculture except at extremely and unacceptably high social costs.

Assuring Japanese food security is a matter of interest for both Japan and the United States.

We recommend that for its part, Japan should establish a contingency wheat and feedgrains reserve. Though expensive in budget-

ary terms, such a reserve would be a far cheaper method of providing food security than high agricultural protection. Moreover, it would not impede the restructuring of Japanese agriculture.

We recommend that both governments should enter into negotiations leading to medium-term supply and purchase commitments. An earlier agreement, the "Abe-Butz Gentlemen's Agreement" of 1975, provided for three years supply and purchase commitments for several important agricultural commodities. These commitments were actually exceeded. The United States has a similar long-term arrangement with the Soviet Union.

Such firm commitments would enable both governments, and their farm communities, better plan long-term policies for the products involved.

POLICY CONSULTATION

A recurrent problem in United States-Japan agricultural trade relations has been the tendency on the part of both governments to make unilateral decisions without proper awareness of or sensitivity to the interests of the other country. Recent instances include the United States soybeans embargo, the initial American negotiating position on beef and citrus during the MTN, changes in Japanese quota programs, and the Japanese rice disposal program.

The overall agricultural relationship is so important to both countries that very careful attention should be given to improving the quality of intergovernmental consultations. Neither country reacts well to surprise announcements from the other. Comprehensive and frank exchanges will reduce the surprise factor. The main purpose of these exchanges should be to alert the other side to policy changes and sensitize the other country's officials to the economic and political considerations underlying these changes. Annual consultations between the respective departments are a clear requirement, and since political and diplomatic considerations strongly influence agricultural policy in both countries, broader representation is needed at these discussions. At such consultations, all major aspects of each country's food policies should be frankly discussed, including production and consumption trends, trade restrictions, the domestic and international aspects of pricing policies, and each country's major agricultural agreements with

third countries such as the United States-Soviet Union agricultural trade agreement.

CONCLUSION

This chapter recommends some very basic changes in both the domestic and international trade aspects of Japanese agricultural and food policies. The Group understands that implementation of these changes raises some very difficult economic, social, political, and even psychological issues in Japan. Nevertheless, we believe that the changes we have recommended are in Japan's own interests and will be beneficial to Japanese food producers and consumers as well as on United States-Japan agricultural trade relations. While recognizing that the steps we have recommended will take time, we strongly urge the Japanese government to initiate major steps in the directions we have recommended.

CHAPTER VIII

Problems in U.S. Trade Law and the United States-Japan Economic Relationship

In Japan, the United States is and has long been regarded as the principal exponent of a freer international trading system. This perception has been undergoing change, however, largely because of the many instances in which Japanese exports to the United States have become the target of import relief requests or unfair trade practice complaints. There has been increased concern in Japan that while the United States has continued to ask Japan to liberalize access to its market, changes in American trade laws and trade policies have increased, little by little, barriers surrounding the American market. In particular, there is growing concern in Japan that aspects of American "unfair trade practice" laws, in themselves, may act as a subtle and largely unrecognized non-tariff barrier to trade. Many believe that this is not yet the case, but that it is possible in the future, depending on how the present laws are interpreted and whether or not they are further amended in a direction favoring protectionism.

BACKGROUND

American trade laws relating to import relief and unfair trade practices have been in force for many years, but were relatively little used during the 1950s and 1960s. This reflected two important factors. First, the United States had trade surpluses during most of this period and there was relatively little import pressure on major American industries. Secondly, the laws themselves were relatively difficult to invoke. To be eligible for import relief, for example, an industry had

to prove that it had suffered serious injury, a major cause (meaning a cause of more importance than all other causes combined) of which was an increase in imports due to past U. S. tariff concessions. A complainant, therefore, had to prove to the Tariff Commission serious injury; it had to show that increased imports were more important than all other causes combined in causing that injury; and it had to demonstrate that increased imports were the result of tariff concessions. Even if it succeeded in convincing the Tariff Commission, the President was not required to grant relief. The very restrictive nature of the law, therefore, discouraged industries from using it.

The perception was well established in the United States that the unfair trade practice laws were so difficult to successfully invoke that they offered no protection even where protection might be warranted under generally agreed international rules.

By the late 1960s, the international economic situation affecting the United States had substantially changed. The United States began to suffer merchandise trade deficits. Several important industries, notably textiles and steel, clamored for import relief, and the labor movement, which had supported liberalized trade through the early 1960s, had largely turned protectionist by the end of the decade. To discourage a growing trend on the part of import-impacted industries to seek statutory relief on an individual basis, the Executive Branch proposed easier access to import relief and protection against unfair trade practices. The Congress, in the Trade Act of 1974, further expanded upon the Administration's proposals.

"Major" cause, for example, in import relief cases was changed to "substantial" cause (meaning important and not less than any other cause). The link between increased imports and tariff concessions was dropped. Negative findings in countervailing duty and anti-dumping cases were made appealable. In assessing whether a foreign industry were dumping, the Treasury Department was required to disregard home market sales below cost of production, making it easier for U. S. firms to prove dumping and theoretically possible that dumping could be found even when export prices exceeded home market prices. Time deadlines were included in the anti-dumping and countervailing duty statutes, and a new provision was added to the body of trade law allowing the President to retaliate against the imports of countries engaged in unfair measures against American exports.

These statutory changes were accompanied by increased usage of

these statutes by domestic industries seeking protection, in many cases against Japanese importers. However, collection of duties averaged several years after a finding of dumping and there was growing American concern that legitimate petitions were not being accepted by the Treasury Department. In reaction to such complaints, the Trade Act of 1979 further amended the anti-dumping and countervailing duty statutes, primarily by expediting time deadlines for decisions and reducing administrative flexibility.

The anti-dumping case was only one of several actions brought against Japanese television manufacturers, however. There were also allegations of price fixing brought up under antitrust legislation, of subsidization leading to a countervailing duty action based on the remission of the Japanese commodity tax. Escape clause relief was finally granted and a three-year long orderly marketing arrangement reached with Japan in 1977. For Japanese producers and much of the interested Japanese public, these cases suggested that American trade laws could be used by industries in the United States to harass their foreign competitors and impose high legal costs on them.

It should be noted that amendments relating to unfair trade practices and import relief were only a part of the Trade Acts of 1974 and 1979. These acts authorized United States participation in the MTN and implemented the codes and other agreements reached. The overall thrust of both laws were unquestionably beneficial to the broader interests of both the United States and Japan in freer trade.

TWO VIEWS OF THE IMPACT OF AMERICAN TRADE LAWS

We sought the advice of several American trade law experts on the question of whether or not the American legal system, in itself, has become a barrier to trade. The materials, which we have included in the appendix, reflect two sharply contrasting views.

One of these views holds that American import relief and unfair trade practice laws have been amended in ways that permit their use as instruments of protectionism. Advocates of this view argue that there has been a lowering of injury and causality requirements for import relief and an expansion of the definitions of "dumping" and "unfair trade" generally. They also point to the addition of Section 301 in the

Trade Act of 1974 providing new legal bases for trade restrictions and to the procedural changes in countervailing and anti-dumping statutes in the Trade Act of 1979 as protectionist-oriented changes. The uncertainty of the standards embodied in these laws, particularly the dumping standard, operates to deter competition. Since importers generally cannot predict what prices or practices will be condemned as unfair, price competition is inhibited. Moreover, because American trade laws are sometimes very sweeping and overlap with each other and because different administrative channels are involved, there is an incentive for domestic industries to use first one and then another statute, seeking relief from different government agencies and harassing their competition. Even if they are unsuccessful in securing relief, they may well impose heavy legal costs upon the foreign producers, perhaps even deterring them from future entry into the American market. Finally, some proponents of this view argue that American antitrust legislation exacerbates the problem by making it virtually impossible for private industry to reach negotiated settlements or engage in voluntary export restraints. Fearing anti-dumping complaints, foreign exporters may try to agree on sustaining certain minimum prices, only to run afoul of the antitrust law's proscription against price fixing.

Another view dismisses the charge of "legal protectionism." American unfair trade practice laws, admittedly overlapping, are very legitimately designed to protect American industries against unfair trade practices. If the laws have been amended, that is because they were not working effectively in the past and more effective application is consistent with international codes and is politically needed to pursue a liberal international trade policy. Foreign producers have very broad rights under these laws; they can appeal positive determinations. The stricter time deadlines may well benefit them by resulting in early dismissal of frivolous or malinformed complaints. The American legal system is no more a trade barrier than the Japanese distribution system; it is a fact of doing business in the United States, and it operates without substantial bias. Proponents of these views argue against any relaxation of the antitrust laws on the grounds that settlements on a private sector basis would open the door to price fixing and other anti-competitive behavior injuring American consumers. While such settlements may be favored by some foreign traders, they are unacceptable to the United States.

COMPLICATING FACTORS

Discussion of the trade impact of American trade laws is complicated in several important factors. Some of the more important of these are the following:

(1) There is a tendency in Japan to regard the relevant American laws and actions brought under these laws as peculiarly directed toward Japan. In fact, these laws are directed against practices, not countries, and most of the complaints brought under American anti-dumping and countervailing duty statutes do not involve Japanese products. The increase in the use of these laws may reflect a general increase in litigation of all kinds in the United States over the past ten years and thus be a systematic problem rather than one peculiar to foreign trade or to American-Japanese trade. The alternative to litigation may well be increased resort to the Congressional political process for relief.

(2) There is a tendency in the United States, especially in the Congress, to believe that a clear dividing line can be drawn between "fair" and "unfair" trade practices which can be readily determined by the administering authorities. In fact, the existence of "dumping," "subsidies," and other alleged "unfair trade practices" is often extremely difficult to establish, and it is all the more difficult to set appropriate margins of relief. Variations in products between home and foreign markets, in manufacturing processes, in business practices, in taxation systems, and the like do not permit the kind of precision on which the American laws are premised. Foreign manufacturers often cannot determine in a technical sense whether or not they may be dumping, but since the laws are prospective, if foreign manufacturers have mistakenly believed they were not dumping, but are found to be dumping, they can comply and will suffer no penalty.

(3) There is widespread lack of knowledge in both countries about the operations of the law, the business practices, and the intentions of competitors in the other country. What may appear to be "multiple harassment" to a Japanese company could be very well regarded as a very legitimate and overdue exercise of legal rights by an American company.

(4) The fact that the international Anti-Dumping and Subsidies Codes agreed to under GATT auspices are not self-executing treaties in the United States, but require domestic implementing legislation to become effective further increases foreign suspicion. Only the imple-

menting legislation can be considered by the United States administering authorities and courts. Since this legislation differs from the strict wording of the codes and interprets the codes in ways that some believe may depart from international usage, there is concern in Japan and elsewhere that the United States may not be conforming with the spirit and letter of the international agreements. Any violation may be addressed through international dispute settlement mechanisms.

(5) There is much uncertainty about how the most recent changes in American law will be interpreted. While some specialists believe that the Trade Act of 1979 substantially liberalizes trade (especially by adopting material injury standards in anti-dumping and countervailing duty statutes), others argue that the new legislation will result in a rash of anti-dumping and countervailing duty actions. In fact, these laws have not yet been properly tested and no definitive judgment can be made.

(6) Certain procedural elements of the American trade laws give rise to additional Japanese concerns. For example, a provision of the anti-dumping act under which attorneys for complaining parties can obtain under protective order the cost and sales data provided to the American government creates fears by Japanese businessmen that their competitors will be able to obtain access to highly sensitive proprietary information. Protective orders, however, have been long used in American legal practice and are considered by many legal experts essential to the proper administration of the trade laws.

RECOMMENDATIONS

We believe the United States and Japan should give serious considerations to the issues involved in the concept of "legal protectionism" and undertake an examination of American and Japanese legal practices to determine whether a significant non-tariff barrier is involved and recommend any appropriate legislative or regulatory changes.

Such an examination should be carried out on both the private and inter-governmental level as soon as possible. Such an examination should consider, among other factors, the use of the emotionally laden terms "fair" and "unfair" trade practices for categorizing complicated and unclear trade practices, the operation of the time deadlines under

American laws, the locus of the burden of proof under American laws, the consistency of American and Japanese trade policies and laws with international standards, and the feasibility of less litigious means of resolving trade disputes.

Recognizing that issues of law play a major role across the spectrum of American-Japanese economic relations, we urge the Prime Minister and the President to encourage increased contacts and symposia among those in Japan and the United States with a knowledge of or interest in each other's legal systems. Greater familiarity with the legal system of the other country should reduce problems of misperception and mistrust.

As a longer-term solution, we believe the American and Japanese governments should seek to further strengthen international codes dealing with injurious trade practices. No agreement was reached on a "Safeguards Code" at the MTN to further define acceptable import relief standards. The two governments should also seek broader international agreements defining acceptable and unacceptable subsidies and improving anti-dumping rules in the interests of greater simplicity, predictability, and fairness.

Finally, it is possible that because of the overlapping nature of the American trade laws, they could be used to harass foreign competition. We recommended that the American government ensure this does not happen.

Economic Disputes and Political Friction

Do trade and economic disputes between the United States and Japan become more politically visible and embittered than the economic disputes of either country with other trading partners? The Group believes that they do and that this is one of the most serious problems in United States-Japan relations because it places a heavy burden on the relationship and jeopardizes cooperation in non-economic as well as economic fields. It is important to analyze the reasons that United States-Japan economic and trade disputes often become important political issues and to find means of coping with the political problems involved.

The underlying causes of excessive "politicization" of economic issues in United States-Japan relations are both economic and political in nature. On the economic side, the major factors are the size of the trade flow between the two countries, the visibility of many of the products involved, and the rapidity with which competitive conditions in certain industrial sectors change.

United States-Japan trade conflicts are highly visible because the trade itself is highly visible. In 1980, United States imports of one Japanese product, automobiles, will be \$8 billion, larger than the total imports from any other non-OPEC trading partner except Canada. Japan's imports of American agricultural products and raw materials will reach \$7 billion, larger than total Japanese imports from any other non-OPEC nation. American consumers are especially cognizant of Japanese imports because such a high proportion of them are widely-used consumer products such as automobiles and televisions or basic industrial products such as steel. The Japanese public is highly aware

of the importance of American agricultural products, such as soybeans, to Japan's food supply. The rapidly changing patterns of competitive advantage in product sectors between the two countries, often aggravated by wide foreign exchange rate fluctuations, add to the stress of adjustment.

In addition, the persistence of certain economic conditions, such as low United States productivity growth and the bilateral imbalance of merchandise trade reinforce and feed stereotypes — that the United States is declining in economic terms and that Japan does not play the trade game fairly. These stereotypes shape public thinking and are often reflected in the public statements of politicians and in the media. They strengthen the sense of righteousness by each country's publics and often governmental leaders in their country's position on trade issues, reducing the room for quiet, negotiated compromise and increasing the chances of polarization of national attitudes and politicization.

In previous chapters we have discussed many of the bilateral economic issues in United States-Japan relations, including low productivity growth, the question of whether or not the Japanese market is closed, agricultural protectionism, and the handling of macroeconomic issues. However, even if all our recommendations on these subjects were fully implemented, there would still be troublesome trade disputes simply as the result of the changing nature of international competition between two highly dynamic societies. Learning to cope with inevitable economic frictions, therefore, is an essential part of improving the climate of the United States-Japan economic relationship.

To learn more about the political dynamics of economic problems and their lessons for the future, the Group commissioned studies by American and Japanese scholars on the politics of several recent economic issues — steel, automobiles, citrus and beef, government procurement policy, and macroeconomic policy coordination. These studies illustrated a variety of bilateral economic disputes, including disputes over Japanese imports into the United States, barriers to American exports to Japan, and broader macroeconomic issues. The full studies and the conclusions and recommendations of the authors appear in the appendix. A number of lessons deserve treatment here.

DOMESTIC POLITICS

Increased Understanding of Each Other's Economies and Domestic Political Processes

Many Japanese and Americans have little appreciation for the other country's relevant domestic political interests involved in any bilateral economic dispute. Some Japanese still look back to the dependent postwar relationship with the United States, leading them to be impatient with the inability of the United States to adopt a generous policy toward Japan as in the past. On the other hand, some Americans still have an image of their country as the dominant partner of a dependent relationship and expect Japan to agree to American requests at any cost if enough pressure from the outside is applied. Another misleading image, commonly held in the United States, is that of "Japan, Inc.," where industry and government are perceived as working closely and harmoniously together. These images are superficial and false. The fact is that neither government can easily make concessions to the other on issues of importance to large domestic interests. In both countries domestic interest groups have been increasingly assertive, at the same time more international economic coordination has become highly desirable.

The Group believes that policy makers in both countries need to pay much greater attention to the domestic political configuration of the other side as well as their own in working out settlements to bilateral economic issues.

In this regard, it is important to reiterate the need to internationalize both Japanese and American societies. We have made a number of recommendations on this subject in Chapter I, suggesting the need for greater contacts among governmental officials (especially parliamentarians) and private sector leaders. We have also urged that both countries train and efficiently use more experts knowledgeable about the other country and skilled in communicating with its officials.

It is particularly important to improve Japanese understanding of the American political process. American politics are vocal and decentralized, generating an enormous volume of words and actions, many of which have little lasting impact. Since both the Congress and the Executive Branch have a role in determining United States trade policies, there is no single, authoritative voice. This is often a source of

confusion to Americans as well as to non-Americans. The Japanese media naturally reports those that refer to Japan often without careful analysis of their significance. Statements of American members of Congress and business leaders often receive wide publicity in the Japanese press, while sometime even the Japanese Foreign Minister's visits to the United States receive very scanty American media attention. **We urge the Japanese government, media, and other leaders to help their countrymen put specific United States events in broader perspective. Not every Congressional speech matters; not every criticism of Japan reflects a broadly or deeply-held view.**

For both governments, but especially for the American government, it can be very useful to encourage those politicians or other leaders who hold misleading or superficial images to travel to the other country. This exposure to the other society, its complexities, and the difficulties its officials face in making concessions or dealing with domestic pressures, can be constructive in educating those who advocate simplistic solutions to bilateral trade problems or believe that major and immediate concessions are politically feasible.

Political Leadership

Good understanding of the politics of economic issues in the other country will mean very little, without effective political leadership able to sustain a reasonable negotiating position against potential assaults at home. In both the United States and Japan, international economic decision-making power is dispersed among many competing centers. This is especially true in the United States where Congress plays a major role in many trade policy decisions. Past experience has shown that senior trade officials of high ability and with good political connections with either the bureaucracy or parliament of their own country can retain the initiative and facilitate an early resolution of the issues.

The Group believes that for many reasons, particularly the growing importance of trade to both economies, both countries need strong political leaders to take charge of major trade negotiations and facilitate effective political management at home and abroad.

The Use of Legislative or Private Sector Study Groups

In assisting political leaders and governmental officials who manage

bilateral economic relations, a very constructive role can be played by small groups of consequential figures (based in either country or both) which combine detachment from current executive responsibilities with serious attention to the issues. The Task Force on United States-Japan Trade of the House Ways and Means Committee has evolved into one such group. The informal "Trade Study Group" (referred to in Chapter V) is another group. Joint efforts by the United States-Japan Economic Council and the Advisory Council on United States-Japan Economic Relations have been helpful over the years.

We urge both governments to support the efforts of private sector and parliamentary groups willing to give close attention to United States-Japan economic issues. Such groups can play an important role in educating publics and political colleagues and in providing a more detached, non-executive perspective on issues.

BARGAINING TACTICS IN UNITED STATES-JAPAN RELATIONS

American Pressuring

One way economic issues have become highly politicized is through the use of what many Japanese regard as intense American pressure on economic issues and what Americans perceive as the most effective negotiating strategy given the lack of successful alternatives. As shown in the case studies in the appendix, often an initial expression of strong concern by the United States (whether made directly by the American government or indirectly through labor union, business or Congressional complaints) elicits little apparent governmental response by Japan. Those Japanese bureaucrats directly concerned, however, at times suggest more specific and forceful American approaches. When these are forthcoming, they are represented as demands (however tactfully they have been put) by the Japanese media and entangled in a highly complex Japanese domestic policy debate. Since, however, there is some Japanese government movement, it appears as if "pressure" has achieved a result, but from the Japanese perspective, the pressure comes across as bullying and insensitive to the Japanese tradition of decision-making where vagueness is required while a consensus is being worked out.

While strong pressure has been sometimes effective from an American point of view, it has also embittered political relations between the United States and Japan, reinforcing American perceptions of Japanese stubbornness except under threat and Japanese perceptions of the United States as arrogant and presumptuous.

The Group believes that in managing economic conflicts, officials in both governments should work very hard to avoid employing (or seeming to employ) intense, highly visible United States pressure as a catalyst for Japanese policy change.

For the Japanese, the need is to respond earlier to "softer" signals and to find alternative domestic sources of support for internal policy change. For instance, necessary economic changes (such as liberalization of import quotas) should be argued on their own merits, and supported by interest groups with stake in an open international economy. These issues should not have to become issues in American-Japanese relations. For the Americans, the need is not to abandon efforts to influence Japanese policies, but to resist invitations to escalate, to be firm and persistent about United States aims without presuming to dominate Japanese behavior, and to look for issue-specific sources of leverage where possible rather than linking economic issues in a broad package which appears as a frontal challenge to Japan as a society.

We believe that the escalation of differences into major disputes can often be prevented by timely consultations among senior experts from both capitals. When the Japanese and American governments appear to be operating on the basis of different assumptions about economic or trade facts and trends, there should be serious analytical discussions between their senior specialists.

American officials also need to be aware of intruding too deeply on Japanese economic decision-making, particularly upon issues normally considered domestic. Japanese officials should be careful not to invite such intrusion. American pressure has been most resented and least effective where it has been regarded as intruding upon "domestic issues" as in the 1977-78 effort by American officials to secure Japanese agreement to certain macroeconomic targets.

American and Japanese officials should also beware of using the other country as a "scapegoat" for internal problems or issues, despite the short-term political gains there may be in so doing.

Japanese Reticence

The problem of misperception between the United States and Japan in negotiating situations is often exacerbated by different bargaining styles. While Americans often employ an adversary style of bargaining, emphasizing the negative aspects of the case of the other side (as lawyers do in court), Japanese tend to remain reticent. This can lead Americans to conclude that Japanese are acknowledging guilt. American actions, including stronger pressure, based on this assumption in turn can breed further Japanese resentment.

We recommend that Japanese negotiators should speak up more, countering American criticism as squarely as possible, to minimize misunderstandings or misperceptions of their position. When the United States government criticizes Japanese policy or makes specific requests, the Japanese government should respond with rational explanations of its positions and counter-arguments instead of saying nothing, appearing to acquiesce, or simply saying "no."

Summit Diplomacy

Negotiators should beware of attempting to force concessions on specific issues by linking them to the success or failure of a summit meeting. Because of the importance of the United States in Japan's pattern of international relations, meetings between the Prime Minister and the President assume considerable significance to Japan. Such meetings are useful for facilitating decisions on important issues, but only if the groundwork has been carefully carried out at the working level. Threats (or implied threats) to cancel summit meetings or to portray them as unsuccessful in order to force concessions on issues where deep and serious disagreement exists will not be productive.

Mutual Benefits

A cardinal principle in American-Japanese diplomacy should be an effort to negotiate on the basis of reciprocal national benefit. If one government or the other appears to be making repeated concessions, this will undoubtedly embitter the political atmosphere and

encourage a public backlash against further concessions in the country which is yielding.

In a new, equal partnership, both the United States and Japan have many adjustments to make. Few economic disputes are black and white. Both governments should enter negotiations with an eye not only on what they may gain, but what they should give up in order to achieve a successful agreement.

Conclusion

Each year, Japan and the United States together produce about 35 percent of the world's new output and engage in almost 20 percent of the world's trade. For this reason, the two countries' success in maintaining a close, mutually beneficial relationship is not only vital to their own prosperity and security, but critical to the world as a whole. Progress in solving the broader problems of the international economy depends in large part on a close, effective United States-Japan partnership.

In the preceding pages, we have repeatedly stressed that in any relationship as encompassing, intense, and diverse as that between Japan and the United States, there will inevitably be some differences of interest and some friction. What is essential is that this friction be viewed in a broader perspective and not be allowed to imperil the overall relationship.

The Japan-United States Economic Relations Group has been a unique experiment in the two countries' relations. Never before have the two heads of government jointly requested a binational group of private citizens to examine the issues affecting the relationship and make policy recommendations directly to them.

We all believe this experiment has been highly successful. During the past year, we have engaged in many hours of intense discussion and as this report demonstrates, have been able to arrive at common points of view on many issues. The Group has sponsored research involving both Japanese and American experts, and believes that this kind of joint policy oriented research can have an important impact on improving mutual understanding of bilateral and global problems.

In the past year, we could examine only some of the many challenges the two countries face in their economic interactions with each other and with the rest of the world. We chose to give attention first to those issues which have been most visibly troubling the United States-Japan economic relationship. We feel that a number of potentially important problems need further attention. These include not only issues of trade and institutional structure, but also those involving the shared global responsibilities of a more comprehensive American-Japanese partnership. Their consideration would benefit from further examination by a binational group not burdened with day-to-day governmental policy responsibilities.

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