U.S.-JAPAN RELATIONS: GROWING INTERDEPENDENCE

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What a difference a few years make. A few years ago, Ford Motor Company and other American automakers were locked in a fierce battle with their Japanese counterparts. Japanese manufacturing costs were said to be lower and the quality of the cars higher. U.S. makers disputed these claims, insisting that quality differences were cosmetic at best, and sometimes suggested that most or all of the Japanese advantages were consequences of unfair trading practices. It seemed to be a war which the United States was losing.

Since this war began, companies in both countries have had brushes with bankruptcy. In the United States, Chrysler Corporation required a government-guaranteed loan in the early 1980's to stay in business. Japan's Toyo Kogyo Company, Ltd., maker of Mazda, got help from its leading bank, Sumitomo Bank, Ltd. after its rotary-engine cars proved unpopular at the time of the 1973–74 energy crisis. Sumitomo dispatched executives to bring Toyo Kogyo back from the brink. Both companies had returned to financial health by the mid-1980's. If Mazda was closely identified with its leading bank in the 1970's, today its leading partner appears to be none other than one of its former rivals, Ford Motor Company. While Sumitomo Bank now apparently feels a little like a jilted lover, Ford and Mazda's relationship, like many marriages, has its ups and downs but still seems to be getting stronger over time. Ford has, for example, reportedly assigned to Mazda major responsibility for engineering work on its not yet introduced U.S. small car line. This line will probably replace the popular Ford Escort and is responsible for distributing the Mercury Tracer, a product of Mazda engineering and Mexican labor. In a sentence, Ford has become dependent on Mazda. Sumitomo's displeasure with Mazda apparently reflects its belief that Mazda relies on Ford. This mutual dependence serves as a metaphor for the two nation's economies. While far from full realization, this interdependence could become one of the major themes of the closing years of this century.

While the argument is usually that the United States depends on Japan, the relationship goes both ways, as the following examples will show.

INTERNATIONAL FINANCIAL LINKAGES

"When America catches cold, Europe or Japan gets pneumonia." This old expression is still true: exports, while not as critical as in some other economies, still play an important role in Japan. When the yen started appreciating against the dollar in early 1985, Japanese companies had to either raise prices, reduce overseas sales, or accept lower profits. They did a little of each, with the result that unemployment rose and profits in export-dependent industries plummeted. A severe recession in the United States would also have led to more unemployment in Japan.

Increasingly, the economic virus can cross the Pacific in the other direction. According to Japanese government data, Japanese firms and individuals purchased $49.4 billion (net of redemptions) of U.S. private and government securities in 1986, the latest year for which data is available.[1] Much of this went into U.S. government securities to help to finance the U.S.

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[1]Bank of Japan, *Balance of Payments Monthly,* April 1987, p. 79.

government deficit. The result was that Japanese funds directly and indirectly financed perhaps a quarter of that deficit. Were these funds not available, the government would have to pay higher interest rates to attract the funds from somewhere else, putting more pressure on the deficit or creating pressures for higher taxes. In addition, borrowers ranging from home buyers to U.S. corporations wanting to expand would also pay higher rates. Some would choose not to pay the higher rates, leading to lower overall investment. Thus, Japanese funds enable higher levels of investment by American companies. In turn, some of this investment strengthens the ability of U.S. firms to compete with Japan.

The deepening financial interdependence of the United States and Japan (and incidentally of other industrial countries) was dramatically illustrated by the events of 1987. The Group of Seven industrial nations (the United States, Japan, West Germany, France, the United Kingdom, Italy and Canada) agreed to early 1987 to stabilize the value of their currencies in an agreement that has become known as the Louvre Accord. An essential corollary was that interest rate policies would also be coordinated; otherwise, differential movements in these rates would create changes in the demand for currencies, leading to exchange rate instability.

Things went well at first, but in the early fall of 1987, the Americans and the Germans disagreed about which way interest rates should go. Already uneasy for a variety of reasons and sensing exchange rate instability and possibly higher interest rates, the stock markets panicked, sending equity prices sharply lower in New York, London, Tokyo and elsewhere.[2] The dollar went into a deep dive that lasted until early January 1988.

At this writing in mid-1988, there continues to be a sense of unease in both the currency and stock markets towards a possible recurance. American security analysts, anxious about foreign investors pulling their money out of this market, keep a wary eye on large Japanese institutions, as well they should. Aside from less liquid, direct investment in factories, real estate and the like, Japanese public and private investment in the United States at the end of 1987 was an estimated $164 billion out of a total foreign indirect investment of $1.3 trillion.[3] Should Japanese and other foreign investors quickly withdraw from the bond or equity markets, the market meltdown of 1987 would seem like a minor accident.

Banking illustrates another of the ways in which financial linkages between the United States and Japan are deepening. For a variety of reasons, Japanese banks, now the world's largest with 12 of the 20 largest positions as measured by assets, have moved into the United States in a big way. While most obvious in California and New York, the main places where subsidiaries serve the public, they are important providers of financial services to government and corporations throughout the country.[4] According to the Federal Reserve Board, Japanese banks had 9 percent of all outstanding loans to government, corporations, and individuals in the United States as of June 1987. At the end of 1983 the figure had been only 5 percent, leading to fears of increasing international friction over this issue.[5]

[2]The Japanese however added to their stock holdings in 1987 while Americans and the British were reducing theirs, according to Salomon Brothers International, Ltd.

[3]Calculated from data in U.S. Department of Commerce, *Survey of Current Business*, June 1987 and March 1988 issues.

[4]For details, see the Japan Economic Institute publication "Japanese Banks in the United States, "*JEI Report* No. 3A, January 22, 1988.

[5]*Nihon Keizai Shimbun* (Japan Economic Journal), March 12, 1988, p. 1. These figures to some extent double-count the figures on indirect investment above to the extent that Japanese banks finance their U.S. activities with Japanese funds.

TECHNOLOGY

While at one time United States industry clearly had the most advanced technology in the world, that is no longer always the case. While data on patents is notoriously unreliable, some of the latest evidence is at least suggestive. The Patent and Trademark Office reports that in 1987, foreigners accounted for 46.6 percent of all patents issued in the United States, a figure which has doubled in the past twenty years. The Japanese received more U.S. patents than anyone else, accounting for 19.3 percent of total patents used. The percentage of all patents awarded to Japan has doubled in under ten years. Three Japanese companies, Canon Kabushiki Kaisha, Hitachi, Ltd. and Toshiba Corp. were the top three corporate recipients, all finishing above General Electric Co., which had been first until 1986.[6]

To the extent that technology makes life better, Americans benefit from the Japanese, either in imported products that embody the new technology or by licensing agreements that permit the use of products produced in America. If technology is a critical part of products or services which we value highly, we become dependent on it.

Levitation transportation technology (maglev) could become such an example. Maglev uses superconductivity as a means to help propel trains at speeds as fast as 300 miles per hour. In addition to speed, it is potentially extremely safe, quiet and in some respects cheaper than conventional technology.[7] Amtrak, the national rail passenger corporation, has expressed an interest in using Maglev for transporting people between airports and population centers, thereby permitting a wider dispersion of airline traffic.[8] While the United States debates whether to fund research for the project,[9] Japan and West Germany have developed experimental prototypes. Allegedly, Japan is ready to move toward the first truly operational system.[10] While the benefits of the technology are obvious, it is not clear how the United States could compete. There are said to be no U.S. companies capable of developing the new technology, and Amtrak is severely strapped for funds. Using German or Japanese firms to develop a system for the U.S. would be an easy way to recap the benefits for U.S. travelers.

Better technology exchange is only one reason why, at the corporate level, Japanese and American firms are developing closer links. Japanese automobile firms now generally have design staffs in the United States to better use American design talent and to stay tuned in to trends in this country, its most important overseas market. The dependence of Ford on Mazda for engineering, design and products has already been noted. The International Trade Commission estimates that the Big Three U.S. automakers imported $5.6 billion of parts in 1986, accounting for 6 percent of the trade deficit that year.[11] Many of these parts came from Japan.

[6]"Foreigners Received Nearly Half of all Patents Issued Last Year, PTO Reports," *Daily Executive Report,* February 29, 1988, p. A-2.

[7]See article by Masaru Ibuka, Honorary Chairman, Sony Corp., "'All Aboard' the Floating Train," *Sankei Shimbun,* May 9, 1988.

[8]Telephone conversation with Amtrak official, March 1, 1988.

[9]See for example, "U.S. Dropping Behind Japan in High Speed Transportation Technology, Senate Told," *Daily Report for Executives,* February 29, 1988, p. A-5.

[10]*Ibid.*

[11]*Washington International Communications* (American International Automobile Dealers Association), February 19, 1988, p. 5.

For U.S. companies, competing against Japan increasingly means using Japanese companies as partners or suppliers. Sometimes, U.S. policies intended to protect U.S. companies by making life difficult for Japanese makers end up damaging American companies. The 1986 semiconductor accord and its consequences are a case in point. The purpose of the agreement negotiated at Washington's request, between the United States and Japan, was to establish minimum prices for computer chips sold by Japanese makers in the United States and in third world countries. It was hoped American makers would benefit by being able to sell their own chips at higher prices, while Japanese manufacturers would sell fewer chips at steeper prices.

After the agreement was signed in August 1986, Japanese companies, with the support of the Japanese government, reduced exports, believing that with higher prices fewer chips could be sold. Between late 1986 and early 1988, however, demand for the chips boomed. American users of Japanese chips, including personal computer makers, suffered because they could not get a supply at a reasonable cost. Japanese personal computer makers could supply themselves with chips, ending up in a superior competitive position as a consequence of the accord the Americans had insisted upon.

DIRECT INVESTMENT

Direct investment—buying a controlling interest in a new or established enterprise—is closely related to technology transfer. Japanese direct investment in the United States totalled about $30 billion at the end of 1987,[12] spread among manufacturing, real estate and other activities. Sometimes, the investment takes the form of building new facilities, as with Toyota's automobile plants in Kentucky; other times it involves buying existing facilities.

Direct investment has another distinguishing characteristic: it involves many people. Japanese manufacturing firms alone employed about 135,000 in the United States at the end of 1986, according to the Japan Economic Institute.[13] In small communities, the effect of a new Japanese factory can be enormous. The effect, of course, is more than in just the numbers of people. While the data is sketchy, direct investment also leads to international technology transfer.[14] Some of the technology, as well as management styles and quality specifications, may spill over into domestically-owned firms. As Japanese firms move more production overseas in response to the soaring yen, the United States is likely to get a big chunk of the most technologically sophisticated investment, speeding the transfer process.

Important as the Japanese direct investment is, the Japanese are not the leaders, accounting for only 12 percent of the total investment outstanding in 1987.[15] In 1986, the last year for which comparable data is available, Japan was well behind the United Kingdom, which had more than twice as much investment, and the Netherlands, which had nearly twice as much.[16]

[12]Calculated from data in *Survey of Current Business,* June 1987 and March 1988.

[13]Susan MacKnight, *Japan's Expanding Presence: 1986 Benchmark Survey,* (Washington, DC: Japan Economic Institute, 1987).

[14]U.S. Congress Office of Technology Assessment, *International Competition in Services,* OTA-ITE-328 (Washington, DC: U.S. Government Printing Office, July 1987, pp. 191–221.

[15]Calculated from data in U.S. Department of Commerce, *Survey of Current Business,* June 1987 and March 1988.

[16]U.S. Department of Commerce, *Survey of Current Business,* August 1987.

If Japanese and other foreign investment has an important role in the United States, the effects in Japan may be even greater. As Japanese firms build factories abroad, new concerns are arising about the "hollowing out" of the Japanese industrial structure, a situation in which much of Japanese manufacturing would be done abroad, leading to much higher unemployment at home. So far that has not happened: it is still far more influenced by macroeconomic conditions than by increasing foreign investment. According to Japan's Ministry of International Trade and Industry (MITI), in fiscal 1986 which ended March 31, 1987, overseas production as a percentage of total production by Japanese manufacturers was only 3.2 percent. MITI estimates that the figure reached 3.7 percent in fiscal 1987.[17]

JAPAN'S ROLE IN MARYLAND

If the United States and Japan have, at least in the past, engaged in economic war, Maryland has been among the battlegrounds. Two of the leading manufacturing industries represented in the Baltimore area, steel and automobiles, have endured Japanese competition for nearly two decades. While the effect of Japanese competition on the operations of Bethlehem Steel and General Motors in the Baltimore area is particularly difficult to assess, many Marylanders feel victimized. Consider the recent comments of the Congresswoman Helen Bentley who represents the district around the two plants:

> Behind this massive penetration of foreign markets is a system which can best be described as economic totalitarianism, a government-directed enterprise in which all the energies of Japan have been mobilized to overwhelm the world competition. It is a national conspiracy directed from a central command post, a squat 11-story building in central Tokyo, the headquarters of MITI, the Ministry of International Trade and Industry . . . .
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> . . . The Japanese themselves have termed their centrally run operation the "Bureaucratic-Industrial Complex," one that is becoming as potentially dangerous to world stability as the military-political threat of the Soviet Union.[18]

The Congresswoman sees the situation as virtually an undeclared war. Many would take issue with her description of the Japanese economy as centrally directed; however, there is no denying the intensity of her feeling. Nor can one deny that jobs have been lost in Maryland as Japan has expanded its markets in this country. It is altogether different to deny that for Maryland, there are significant benefits to doing business with Japan. For one thing, there are the benefits produced by Japanese products. Thousands of Marylanders drive Japanese cars, believing them to offer better value than the domestic competition. Depriving drivers of that choice would reduce their sense of well-being. For other products the benefits are even clearer: video cassette recorders as a mass-market consumer product are the consequence of Japanese ingenuity. While few would argue that VCRs are absolutely necessary, millions nationwide find them a welcome addition to their homes. Japanese medical products help the sick get better and the aged lead more comfortable lives.

Almost adjacent to the beleaguered auto plant and steel making facilities in Baltimore is a powerful source of foreign trade-related job-*creation,* the Port of Baltimore. The port estimates that in 1984 automobile-import employment alone created 1,163 jobs.[19] While the

[17]*Nihon Keizai Shimbun,* April 22, 1988, p. 5.

[18]Comments of Helen Bentley in the *Congressional Record,* March 1, 1988, p. H540.

[19]Telephone interview with Jim Hobson of the Port of Baltimore, March 1, 1988.

Port doesn't provide a breakdown by automaker or nationality, it's no secret that most of that was Japanese. In 1986, the port did $3 billion worth of business in Japanese imports, two-thirds of which was in automobiles.[20]

While much smaller than in several of the West Coast states, Japanese manufacturing firms have set up shop in Maryland, or acquired American firms with Maryland plants. The largest Japanese majority-owned manufacturing employer in the state is Locke Insulators, which employs 400 people in Baltimore. Terumo Medical Equipment of Elkton has 230 people on its payroll, while Shimadzu Scientific Instruments of Columbia has 80. In addition, Sun Chemical, a subsidiary of Dai-Nippon Ink, has a factory in Williamsport.[21] No Japanese bank at the time of this writing has an office to perform banking functions in Maryland.

In short, while the economy of Maryland can feel the cold wind of Japanese competition, some warm breezes do come this way. If, as the Congresswoman suggests, the economic relationship amounts to a war, it is a most peculiar one, with the Japanese side contributing in many ways to the American's continued ability to do battle.

HOW JAPAN DEPENDS ON THE UNITED STATES

The new reliance on Japan may come as something of a shock to many Americans. If it's any consolation, the relationship goes both ways; Japan also needs us. Obviously, American weapons help protect Japan; U.S. exports as noted above figure prominently in the Japanese economy. According to the Economic Planning Agency of Japan, exports to Japan were about 18 percent of the country's economy during most of 1987.[22] The Ministry of Finance figures that the United States received about 37 percent of Japanese exports during the same period.[23] Putting the two figures together, about 7 percent of Japanese output ended up in the United States. Losing even a fair chunk of that would be very harmful to the Japanese economy.

If anything, Japan values its imports from the United States even more than its exports. Japan relies on its trading partners for much of its food, industries and raw materials. Self-sufficiency in food production on a value basis, which was 78 percent in 1970, had dropped to 71 percent by 1985.[24] Much of the difference comes from the United States.

The United States has a large balance of trade deficit with Japan, reaching about $50–60 billion in 1987, varying on the basis of which set of figures one uses. If dependence is measured by imports, this figure seriously understates Japanese dependence. What Japan imports from the United States might be replaced with other foreign suppliers, but would be hard pressed to produce the products domestically. While Japan produces little wheat or soybeans, for example, and almost no petroleum, all three are of vital importance to the economy. By comparison, U.S. imports from Japan often have domestically produced substitutes.

In short, the products imported by Japan and the United States are a little like water and diamonds, to repeat an analogy famous in the history of economics. Japan buys something

[20] *Ibid.*

[21] MacKnight, 1987.

[22] Economic Planning Agency, unpublished data.

[23] *Toyo Keizai Geppo*, May 1988.

[24] "Japan, Agriculture, and the MTN," *JEI Report* no. 44A, November 20, 1987.

akin to water, which is abundant, cheap and absolutely necessary. It sells products to the United States which are more like diamonds—hard to produce, expensive and arguably unnecessary. If the monetary value of the "diamonds" exceeds that of the "water," the resulting balance of payments surplus to the diamond producer tells us little about who is dependent on whom.

WHERE DO WE GO FROM HERE?

By now it should be clear that the economic relationship between the United States and Japan is a complex one. Solving the problem is obviously not a simple matter of stopping the importation of a product that seems threatening.

First, it is obviously important that we think carefully about what we are doing. Otherwise we could shoot ourselves in the foot. Careful study of a proposal could help, if we are willing to believe the results. The voluntary export restraint on automobiles is an example of a trade action that, had policymakers heeded what the economists were telling them, could have prevented a lot of harm. This voluntary restraint sets a ceiling, broken down by Japanese manufacturer on the number of cars each can sell in the United States each year. It began in 1981 as a means of reducing competition with American makers and protecting American jobs. Economists predicted that it would lead to higher prices for both domestic and foreign cars, a small employment gain at a high cost for American automobile workers and diversion of the demand for Japanese cars to those from other foreign countries. They added that it would pale in importance compared to macroeconomic changes such as exchange rate movements and rates of economic growth.

Now, seven years later, with the Korean-made Hyundai the leading import in this country, the economists have proven correct. Only in 1987, two years after the yen began a sustained rise, did Japanese makers export less than the quota amount, demonstrating the strength of macroeconomic, compared to microeconomic, forces. A new Organization for Economic Cooperation and Development (OECD) study puts the cost to consumers in the form of higher prices at between $93,000 and $250,000 per job saved, showing the high cost of job protection.[25] In short, the OECD concludes that the voluntary restraint has achieved only some of its objectives, and those have been expensive.

Second, we need to learn from the Japanese. That means speaking and reading the language, so we don't find ourselves not knowing what Japanese regulations are. Recently, U.S. firms hoping to compete in the multi-billion dollar Japanese processed foods industry waited months for a translation of new regulations, with the result that they had inadequate time to prepare a response before implementation. If we permit the Japanese government or industry to decide what we need to know by relying on them for translation, we will often end up disappointed and out-negotiated. This includes technical translation. With the increased flow of technology outbound from Japan, translation of technical publications is a means of assuring that we get our share at a fair price and in a timely fashion.

For U.S. government and industry, these suggestions, if implemented, will imply new job criteria. The Japanese language is so difficult that mastery of the language should be considered a significant accomplishment for hiring and promotion. Government agencies and firms will have to learn to accept the inevitable tradeoff that better language proficiency comes at the expense of other abilities.

[25]OECD, *The Cost of Restricting Imports: The Automobile Industry,* (Paris: OECD, 1988). It is summarized in the *OECD Observer,* February-March 1988, p. 4–7.

Third, we have to better understand where our interests really lie. Too often, American negotiators have demanded that Japanese makers increase the prices they sell to us. What firm would ask his supplier to raise his price? The era of the high yen gives a particularly current example of this phenomenon. The Japanese currency has more than doubled against the dollar in the past three years. In order to recover their costs and maintain their profits in yen, Japanese manufacturers would have to almost double their prices. On the other hand, if they face American competition, raising prices could result in a disastrous loss of market share. They have chosen to increase prices a little, but not double them. Americans might be expected to appreciate the price break they have gotten, but instead we have insisted that the Japanese jack up prices an amount corresponding to the increase in the yen's value. In some cases, such a request amounts to asking that Japanese manufacturers collude; one Japanese firm considering raising prices by itself would be very reluctant once it realized that it would lose market share, and probably profits to Americans and other Japanese firms.

Fourth, we have to pick our fights more carefully. For one thing, as noted with semiconductors, automobile VERs and the recent controversy over pricing in the era of the high yen, doing nothing would have been preferable. In other situations, we have spent years arguing over products whose annual trade amounts to a relative pittance. Even if we are right, it's debatable whether argument has been worth the effort. This leads to a final suggestion—discussing a free trade agreement with Japan, perhaps modeled after the one negotiated with Canada in late 1987. This should, once ratified, substantially reduce the barriers to trade between the two countries.

Negotiating an agreement with Japan will be difficult, taking years to achieve. By the time an accord is reached, interdependence between our two countries is likely to be even greater. The ability to shoot ourselves in the foot will be even greater. We need to start thinking about it now.

SUMMARY

Four years ago, Walter Mondale spoke of a future in which Americans would soon be reduced to sweeping up around Japanese computers. At the time, the metaphor seemed clear enough, but not so now. The Japanese computer might be made in the United States, the American one in Japan. The firm using it might be a Japanese-transplant firm employing American workers. The computer, whether American or Japanese, may use American software and Japanese chips. Yet politicians continue to use the same imagery of war, winners and losers. The interdependence between the two countries is evidence that each market participant, whether a firm or private consumer, sees something to gain and acts upon that perception. If we nurture rather than attack the relationship, those perceptions can become realities, and we can all be winners.