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Author(s): Kanji Haitani
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JAPAN'S TRADE PROBLEM AND THE YEN

/ Kanji Haitani*

The Japanese economy is now at the crucial crossroads. The post-war policy of export-led, high-investment growth has resulted in a set of serious distortions and tensions both inside and outside of Japan. Domestically, the problems are inflation, paucity of social capital and social services, and environmental decay. The 1970 *Economic White Paper* prepared by Japan's Economic Planning Agency declared that the Japanese economy in the 1970s must strive for balance and harmony in the growth process. Specifically, it recommended that Japan move toward increasing the welfare of its citizens. The fruits of economic growth must be used positively for the construction of a truly affluent society with adequate provision of social services that enhance the quality of life. The *White Paper* further stated that the Japanese economy must become truly integrated with the world economy. It deplored the continued existence of protectionism in Japan, and recommended that the programs of further liberalization of imports and capital flows be pursued more vigorously.[1]

Prosperity of any nation today depends heavily on achieving and maintaining an economically harmonious relationship with the rest of the world. Because of Japan's paucity in natural resources, its reliance on other nations is especially high. It is an indisputable fact that for prosperity and even for survival, Japan needs foreign raw materials and foreign markets for its products. It is estimated that by 1975 more than 50% of almost all of its raw-material needs will have to be met with imports. The import dependency ratios will be 80% for copper, 90% for iron and coal, and 100% for petroleum, nickel and aluminum.[2] In order to pay for the imported materials, Japan must export its products. Japan therefore cannot afford to lose its overseas markets, especially the important U.S. markets, to protectionism. This is the fundamental fact of the Japanese economic life.

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[1] *Keizai Hakusho, Showa 45-nen* (Economic White Paper, 1970), Japanese Economic Planning Agency, 1970, pp. 92-93.

[2] *Tsusho Hakusho, 1971* (White Paper on International Trade, 1971), Japanese Ministry of International Trade and Industry, 1971, pp. 335-336.

Unfortunately, Japan in recent years has pushed its export efforts too much and too fast. Perhaps it has done so inadvertently. It has been difficult for Japan to rid itself of the acute sense of insecurity developed over the last century under conditions of chronic foreign exchange shortages. Japan has developed its present oversized export surplus because of the momentum carried over from the days of the "export or perish" philosophy, under which it exported regardless of costs and prices. Although the conditions have now changed, the Japanese find it difficult to shed the old system of export promotion and import restriction, hence the rising trade surplus.

Japan's trade-imbalance problem has a relatively short history. As late as 1964, Japan had a negative trade balance with the U.S. In 1965, for the first time, the balance turned to Japan's favor. Japan's trade surplus with the U.S. rose from \$330 million in 1965 to \$3,210 million in 1971. Its trade surplus with the rest of the world (including the U.S.) increased from \$1.90 billion in 1965 to \$7.79 billion in 1971, while its balance-of-payments surplus rose from \$1.10 billion in 1968 to \$7.69 billion in 1971.

The world-wide currency realignment agreed upon in the Smithsonian Institution meeting in December 1971 resulted in a 17% revaluation of the yen. Japan's trade surplus continued to increase in 1972 in spite of this substantial revaluation. Between 1971 and 1972, the trade surplus increased from \$7.79 billion to \$9.0 billion. The \$4.2 billion surplus in the Japan-U.S. trade accounted for about two-thirds of the U.S. trade deficit for 1972. Japan's Prime Minister Tanaka promised President Nixon at the Japan-U.S. summit meeting held in Honolulu in September 1972 that he would reduce Japan's surplus with the U.S. to "more manageable proportions." Tanaka's failure to keep this promise was certainly one of the key factors that prompted President Nixon to devalue the dollar—for the second time in fourteen months—by 10% in February 1973. The yen has been floated since then, resulting in the de facto second yen revaluation of more than 15%. In less than two years since August 1971, the value of the yen has risen by more than a third against the dollar.

This paper will analyze the nature of Japan's trade-imbalance problem by (1) examining its relationships with the structures of Japan's trade and industry, (2) evaluating the role of yen revaluations as a solution to the trade problem, and (3) exploring alternative solutions. The near- and intermediate-term prospects of the solution of the problem will also be assessed. The discussion will be largely couched in terms of the imbalance in U.S.-Japanese trade and the valuation of the yen vis-à-vis the dollar since these are the areas where the problems are acutest and the need for a meaningful action is most urgent for both economic and political reasons.

Japan's Trade Problem and the Yen Exchange Rate

The rapid increase in Japan's trade surplus was attributable to an equally rapid expansion of Japan's exports, which had two main causes. One was the price inflation in many of Japan's trading partners, especially the U.S. The world-wide inflation caused by the Vietnam War increased the demand for Japanese products as well as raising their export prices. The improvement in the profitability of exports led to an improvement in the outlook of Japanese industrialists, resulting in their ambitious programs of capacity expansion. The second cause of the rapid increase in Japan's exports is related to the first. The ambitious investment programs raised the productivity of Japanese industries, enabling them to maintain relatively stable unit labor costs in spite of rapidly rising wage rates. The U.S., on the other hand, failed to maintain rising productivity, and its unit costs and hence international competitiveness deteriorated rapidly while Japan's competitiveness registered a sharp gain. During the four-year period 1968-1971, the wholesale price index for Japan rose by an average rate of 1.1% per year, while that in the U.S. increased by 3.4% per year. A consequence of this divergence in the two countries' price levels was the flooding of the U.S. markets with Japanese products.

The rapid development of Japan's external imbalances could have been checked if the Japanese Government had taken appropriate measures at right moments. The 1972 *Economic White Paper* notes in retrospect that if the yen had been revalued as early as 1969, Japan's external imbalances would have been rectified relatively easily.[3] The failure to take appropriate actions could be attributed to the following reasons. First, Japan was caught off-guard by the sudden and rapid development of the inflation in the U.S. In spite of the sudden and sharp increase in its exports, Japan was neither capable nor willing to rapidly dismantle the long-nurtured institutions and policies of export promotion and import restriction. The elaborate network of export-promotion measures such as preferential financing of exports, special depreciation allowances for exporters, etc., continued to push Japan's products abroad, while the tight network of tariffs, import quotas and other non-tariff trade barriers effectively prevented utilization of the foreign exchanges earned by ever-increasing exports. Secondly, the Japanese were so used to the notion of a fixed exchange rate that an adjustment of the yen exchange rate was not even considered as a policy variable. The officialdom and business establishment were of the traditional persuasion that emphasized the responsibility of a deficit country in making adjustments. They maintained that the pure and industrious should not be penalized, and argued that the U.S. should put its own house in order. Thirdly, the Japanese failed to understand the relativity of currency adjustments—it made little difference whether the yen was upvalued or the dollar was devalued. Implicit in their adherence to the old yen-dollar parity was their argument that if the exchange rate had to be changed, it should have been done by a dollar devaluation. This insistence revealed their failure to realize the dif-

[3] *Keizai Hakusho, Showa 47-nen* (Economic White Paper, 1972), p. 92.

ficulty of the key currency country to devalue its currency within the then existing monetary system.[4]

The 17% revaluation of the yen of December 1971 from yen 360 to yen 308 to the dollar came as a big surprise to most Japanese. Few had anticipated a revaluation of more than 15%. Most Japanese manufacturers and trading firms had been writing forward contracts calling for payments at the rate of yen 320 to the dollar—a de facto 12.5% revaluation. The Economic Planning Agency had estimated that a 10% revaluation (to yen 320) would slow down the growth rate of Japan's GNP from 8% down to 5% in Fiscal 1971. The trade surplus for Fiscal 1971, which had been estimated to be $7.5 billion without the revaluation, would sharply decline to somewhere below $4.7 billion. The way things turned out, however, surpassed the wildest imagination of the planners and crystal-ball gazers. The 17% revaluation hardly put a dent on Japan's trade and GNP figures. The latest estimates for Fiscal 1972 are that GNP will grow by more than 10% in constant prices over Fiscal 1971, and the trade surplus would be $8.2 billion, only a slight decrease from the $8.5 billion surplus recorded in Fiscal 1971.[5]

Theoretically, an upward revaluation of a currency narrows the country's trade balance by reducing the value of its exports and increasing the value of its imports. Actually, the value of Japanese exports increased rather than decreased after the December 1971 revaluation. This was partly because many Japanese exporters failed to raise their export prices fully in line with the revaluation. In order to maintain their output, employment, and shares of export markets, they absorbed the impact of the revaluation by shaving their profit margins. To the extent that their dollar export prices were not raised to reflect the revaluation, their yen export prices fell. The ability of Japanese producers to continue to absorb the impact of further revaluations is of course not unlimited. It is expected that in each successive round of revaluation, the dollar export prices will be raised increasingly more in line with the extent of the revaluation, and therefore further revaluations will be increasingly more effective in reducing Japan's trade surplus.

A revaluation of the yen can affect Japan's trade balance by way of the price elasticity of demand for exports and imports. The price elasticity of demand is defined as the ratio of the percentage change in the quantity demanded to the percentage change in the price; it measures the responsiveness of the quantity demanded to a price change. The well-known Marshall-Lerner condition states that a devaluation or revaluation of a currency, whichever is required by circumstances, will always improve the trade

[4]In this paper the terms "revaluation of the yen" and "appreciation of the yen" are used interchangeably. Normally the former implies a flexible exchange-rate system or a float. The two become essentially the same, however, under a regime of "dirty" floats where a central bank actively supports an exchange rate which it deems desirable. It is widely recognized that this is indeed the case with the current yen float.

[5]*Bank of Tokyo Weekly Review,* October 30 and December 11, 1972.

balance of a country as long as the sum of the export and import price elasticities exceeds one in absolute terms.

Estimation of price elasticities is difficult and various estimates are likely to differ from each other. Houthakker and Magee estimate that for the period 1951-1966, the price elasticity of demand for Japanese exports was minus .80 and that for Japanese imports was minus .72.[6] Araki's estimates of comparable elasticities are minus 2 and minus .3.[7] For the purpose of assessing the effect of a change in relative prices on Japan's trade surplus, what matters is not their separate values but the sum in absolute terms, which is 1.52 as estimated by Houthakker and Magee and is 2.3 according to Araki. The Marshall-Lerner condition is amply met by either estimate. This is very significant. It means that a revaluation of the yen will necessarily reduce the trade surplus, and a devaluation will necessarily increase it, other things being equal.

Since the price elasticities of Japan's trade amply meet the Marshall-Lerner condition, reducing the trade surplus is merely a matter of revaluing the yen by a large enough amount. Of course a substantial revaluation, say to yen 200 to the dollar, would adversely affect the output and profit of many of Japan's producers who engage heavily in exporting. Many small businesses that are barely breaking even under the present rate of exchange would undoubtedly fail. The trade surplus would decline sharply and approach an equilibrium, at which point the only products that could be exported profitably would be those in which Japan enjoys genuine comparative advantage. The crucial question is: Are the Japanese willing to accept this drastic and painful adjustment? Let us now turn to a discussion of the Japanese attitude toward revaluation.

It is interesting to note that the anti-revaluation sentiments in Japan are not based on any rational calculation of the costs and benefits of a revaluation, but are instead influenced strongly by the vocal objection of some business groups whose interests would be adversely affected. Take, for example, the exchange loss of revaluation. Japan's shipbuilding industry strongly objected to revaluation in 1971 because it had yen 1,917 billion worth of long-term export credit denominated in dollars.[8] The industry maintained that its exchange loss due to a moderate revaluation of the yen would be roughly equal to one year's after-tax profits of the entire industry. Such pronouncements decisively influenced the popular belief that revaluation is somehow not in the best interest of the nation. The fact that other industries which had external liabilities denominated in dollars may have a windfall gain from a revaluation was ignored. As always, it is the party who suffers that is the most vocal. Consequently, the damages tend to be overstated. The 1972 *Economic White Paper* reports that the exchange

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[6]H. S. Houthakker and Stephen P. Magee, "Income and Price Elasticities in World Trade," *Review of Economics and Statistics*, LI, May 1969, pp. 111-125.

[7]*Boeki to Kanzei* (Trade and Tariffs), June 1961, p. 66.

[8]Nihon Keizai Shimbun-sha, *308-en Shinjidai* (The New 308-yen Era), (Tokyo: Nihon Keizai Shimbun-sha, 1972), p. 61.

loss caused by the December 1971 revaluation reduced the shipbuilding industry's after-tax profits by 335% in the second half of Fiscal 1971 against the first half. For the same period, the petroleum industry's after-tax profits showed an increase of 706% which was attributable to the revaluation. In addition to the petroleum industry, the textile, chemical, steel, automobile and trading industries showed exchange gains from the revaluation. The losers were, in addition to the shipbuilding industry, general machinery, electric machinery, and shipping industries. All told, the Japanese industries showed a decrease in after-tax profits of only 2.3% which was directly attributable to the exchange losses caused by the revaluation.[9]

It has also been argued that revaluation is counter to national interest because it depreciates the yen value of the dollar holdings of the Japanese Government. A moment's reflection will indicate, however, that the loss is a nominal, bookkeeping loss. Whether its yen value increases or decreases, the purchasing power of a given amount of dollar reserves does not change after the revaluation of the yen. One dollar will buy one dollar's worth of goods and services in the U.S. either before or after the revaluation, and that is the only meaningful assessment of the true value of the dollar.

Revaluation has also been attacked as causing a slowdown in Japan's economic growth. Both the slowdown in exports and the increase in imports have an effect of reducing the aggregate demand for Japanese products. It is of course very difficult to estimate exactly what the impact of a revaluation would be on the economy's growth rate. Japan's real GNP increased at an annual rate of 10.5% during Fiscal 1971 and is estimated to have increased by more than 10% during Fiscal 1972.[10] At any rate, the demand-reducing effect of a revaluation can be countered by generating other types of demand in Japan, notably public demand for social overhead capital and social services. And this shift in resource allocation is precisely what the popular consensus in Japan now demands. To be sure a certain amount of transitory unemployment is unavoidable. But this would not be a very serious problem, given the acute labor shortage in Japan.

Unlike the alleged shortcomings of revaluation which are mostly nominal, the advantages of a revaluation are real and substantial. First and foremost, revaluation benefits Japan by improving its terms of trade, which are defined as the ratio of export prices to import prices. The ultimate purpose of international trade is to raise the material well-being of the residents through international specialization. The gains from trade will be greater, the better the terms of trade are. A yen revaluation raises dollar export prices and lowers yen import prices. This improvement in Japan's terms of trade means that the Japanese can receive from foreigners more foreign goods and services for a given amount of Japanese products exported. Of course every nation wants to attain the best terms of trade possible. The extent to which a nation can improve its terms of trade by raising the value of its currency,

[9] *Keizai-Hakusho, Showa 47-nen* (Economic White Paper, 1972), p. 81.
[10] *Bank of Tokyo Weekly Review,* December 11, 1972.

however, is limited by the nation's ability to balance its payments with the rest of the world. An overvaluation of the currency leads to a balance-of-payments deficit, necessitating a devaluation of the currency. On the other hand, a country with an undervalued currency (and the attendant surpluses in the trade and payments balances) is foregoing an opportunity to improve the well-being of its populace. In fact, it is giving away its products to foreigners at unnecessarily low prices. And the country is likely to be criticized for what amounts to a charitable act simply because it runs surpluses in its trade and payments accounts. A revaluation in such a case will have a double benefit by improving the welfare of the people and improving the nation's international relations.

Another benefit of revaluation is that it helps to rationalize the Japanese economy. One of the disadvantages of maintaining an undervalued currency is that it leaves a country without a clear-cut guide as to what industries have comparative advantage in international trade. Since the undervalued currency makes exports of the country unduly competitive, even those industries that lack comparative advantage tend to become exporting industries. This is exactly the situation that exists in Japan today. Further revaluations of the yen will turn some of Japan's less efficient industries away from exporting. This will have double benefits. First, it will allow Japan's trading partners greater opportunities to sell their products to Japan. If a revaluation makes Japan's textile and aircraft industries less competitive, for example, then Japan will have to import textiles from less developed countries and aircraft from more advanced nations. Only those Japanese industries that can continue to export with comfortable profit margins under an equilibrium rate of exchange can be said to possess true comparative advantage. Secondly, the resources released from the less efficient industries can be channeled toward more efficient industries in which Japan enjoys true comparative advantage. Of particular importance to the overheated Japanese economy is the fact that labor released from the traditional, small-scale industries can be utilized by more efficient modern sectors of the economy, alleviating the acute labor-shortage problem that threatens to be a major bottleneck in Japan's economic growth in the decades ahead.

An exact opposite of the above situation applies to the U.S. economy. Because of the overvaluation of the dollar and the undervaluation of the yen, many U.S. industries that would be competitive under an equilibrium rate of exchange experience difficulties in competing with Japanese industries. The popular belief that imports from abroad take jobs away from the American worker is correct in so far as the flux of imports is caused by the rate of exchange that is out of balance. Revaluations of the yen would help increase the number of jobs in the U.S.

In which manufacturing industries would the U.S. have a latent comparative advantage in addition to its obvious advantage in agricultural products? Recent developments in international trade theory suggest that a high-wage country like the United States has, by virtue of its high income, a natural advantage in manufactures in the following three areas: First, the U.S. advantage in technologically advanced products appears unassailable. Secondly, new products enjoy monopolistic positions in world trade at least until the production processes become standardized and therefore can be imitated by low-wage countries. The U.S. is the greatest source of new products owing to its high per capita income. Thirdly, the U.S. would have an advantage in the larger, the more powerful, and the more deluxe varieties of ordinary manufactures that other countries are unable to produce economically owing to their smallness and/or lower per capita income. The Japanese would find it difficult to compete with U.S. producers in such products as large passenger cars, 25-inch color television sets, and 20-cubic-foot refrigerators because there does not exist in Japan a large enough demand for such products to warrant mass production. Successive revaluations of the yen would make the prices of these U.S. products increasingly more attractive to the Japanese consumers.

The Trade Problem and the Structure of Japan's Trade

The soaring trade surplus and the failure of the yen revaluation of December 1971 to effectively reduce it promptly have precipitated in Japan a lively discussion on the structural nature of Japan's trade problem. Some observers have even argued that the structural problem is so deep-rooted and fundamental that the trade imbalance cannot be corrected by mere revaluations of the yen.

The concept of income elasticity of demand has a significant bearing on the structural problem of Japan's trade. The income elasticity of demand measures the responsiveness of the demand to a change in income, and is defined as the ratio of the percentage change in the quantity demanded to the percentage change in income. Demand for manufactured goods tends to increase faster than income, and it is said to be income elastic. The demand for primary products (raw materials, including fuels and foodstuffs) is generally income inelastic. A 10% increase in national income, for example, is likely to generate less than 10% increase in the quantity of primary products demanded.

Because of the paucity of natural resources, the basic pattern of Japan's foreign trade has long been that of "processing trade *(kako boeki)*." Japan seeks raw materials from all over the world, adds to them as much value as possible by processing and fabricating them, and exports the end products. The composition of Japan's imports therefore naturally leans heavily toward raw materials. The skewness in the commodity composition of imports is reinforced by the structure of Japan's tariff rates which are lowest for raw materials and rise as the degree of processing or fabrication rises. In 1970, only 15% of Japan's imports were manufactured products, the rest being foodstuffs, fuels, and industrial raw materials. The commodity composition of Japan's exports, on the other hand, is skewed very heavily toward manufactures. In 1970, over 94% of exports were classified as manufactured goods.[11]

The significance of this disparity in the commodity composition of Japan's trade is that the income elasticity of demand for Japan's exports is high and that for imports is low. According to the study by Houthakker and Magee, the income elasticity of demand for Japanese exports was 3.55 and that for imports was 1.23 for the 1951-1966 period.[12] This means that the world demand for Japanese products increased by more than three and one half times as fast as the rate of increase in world income, while Japan's demand for overseas products increased by merely one and a quarter times as fast as the rate of increase in Japan's GNP. With respect to U.S.-Japan trade, the disparity in the income elasticities appears even more pronounced. Araki estimates that for the period 1960-1969, the income elasticity of Japan's exports to the United States was 3.711 while that of U.S. exports to Japan was 0.825.[13]

Herein lies a fundamental problem in Japan's trade. There is a built-in bias toward annually increasing trade surpluses arising from the fact that exports grow much faster than imports. Before 1968, this disparity had been considered desirable since it alleviated Japan's balance-of-payments problem. A deliberate policy of widening the income-elasticity disparity had been vigorously pursued by the Japanese Government. To raise the income elasticity of demand of "heavy" industrial goods (metals, chemicals, and machinery) to total manufacturing output. This so-called "heavy industrialization *(jukagaku kogyoka)*" program has been highly successful. The percentage of "heavy" goods in Japan's exports rose from 49% in 1962 to 75% in 1972.[14] On the import side, Japan's industries have endeavored to reduce the raw material content of their products by various material-saving innovations. As a result, Japan's demand for overseas raw materials has not increased as fast as the increase in Japan's total output.

How could this disparity in income elasticities be minimized? On the export side, the income elasticity of demand may be reduced by revaluations of the yen. The effect of a revaluation on a country's trade balance shows up primarily through its effect on the price elasticities discussed above. In practice, however, both the price and income elasticities must be estimated at a given rate of exchange of relevant currencies. When the exchange rate itself is changed substantially, the elasticities would naturally be affected. It may be argued that the very high income elasticities of demand for Japanese exports were partly explainable by the absolutely low level of the prices of Japanese exports caused by the undervaluation of the yen. Consequently, a substantial revaluation of the yen would lower the coefficient of income elasticity. No estimate of the income elasticities of de-

[11] *Tsusho Hakusho*, 1972, pp. 258-259.
[12] Houthakker and Magee, *op. cit.*
[13] *Boeki to Kanzei*, June 1971, p. 66.
[14] *Boeki to Kanzei*, March 1972, p. 20.

mand for Japanese products for the period following the December 1971 revaluation is available, but the experience of the West German revaluation of 9.2% in 1961 appears to support the view that a revaluation affects income elasticities. The income elasticity of demand for German exports is reported to have declined from about two to about one.

On the import side, the low income elasticity may be raised by either (1) reducing the share of raw materials in Japan's total imports and/or (2) increasing the share of manufacturing goods, especially consumer goods. What is needed is a fundamental restructuring of the Japanese economy so that it will be less dependent on imported raw materials.

The resource needs of Japanese industries should be met by increased imports of processed and semi-processed products. Instead of importing iron ore and coal, for example, Japan should import iron and steel. This restructuring of Japan's industrial production would have two desirable by-products. First, it would alleviate the acute environmental pollution problem, and second, it would benefit some of Japan's trading partners, particularly the less-developed nations, by inducing their development of smelting and refining industries. Unfortunately, however, this program of transforming Japan's industrial structure is time consuming. It would probably take at least a decade before any meaningful reduction in the raw-material content of Japan's imports can be realized.

In 1970, only 3.4% of Japan's imports were consumer goods. Comparable figures for West Germany was 13.3% and for the U.S. 25.5%.[15] There is a potentially very large demand for imported consumer goods in Japan, but the potential has not thus far been realized because of the excessively high prices of imported products. For example, most U.S.-made consumer durables are priced in Japanese retail stores at two to three times the retail prices in the U.S. This is in sharp contrast to the prices of most of the Japanese-made consumer goods that sell in the U.S. at about the same prices as the Japanese retail prices. Unless this price differential is narrowed, a substantial increase in the importation of consumer goods into Japan is not likely to occur.

Three factors may explain the high prices of imported consumer goods in Japan: high tariff rates, discriminating commodity tax rates, and the anachronistic distribution system. Of the three, the least important is the tariff rates. The average tariff rate on manufactured goods in 1972 was about 11% in Japan and 8% in the U.S. The Japanese tariff rates were uniformly reduced by 20% at the end of 1972. As tariff rates come down gradually, other restrictions increase their relative importance.

The commodity tax *(buppin-zei)* plays a prominent role in raising the prices of imported goods, especially consumer durables. The U.S. relies mainly on direct taxes on income and profits to generate government revenue, whereas the greater portion of the government revenue of Japan and

[15] *Tsusho Hakusho*, 1972, pp. 268-269.

most European countries comes from indirect taxes such as commodity tax, sales tax, and turnover tax. Under the rule of the General Agreement on Tariffs and Trade (GATT), the indirect taxes are rebatable to exporters whereas the direct taxes are not. Consequently, the exporter in a country where indirect taxes are mainly used (e.g., Japan) are placed on a favorable competitive footing compared to the exporter in other countries (e.g., the U.S.) where direct taxes are more heavily relied upon. Furthermore, for some products the Japanese commodity tax rates (as well as tariff rates) rise in proportion with the size, capacity, or the degree of sophistication or luxury of the products in question. This practice is particularly discriminating against the products of the U.S. and other advanced countries since Japanese imports from them tend to be larger and more deluxe than their domestic counterparts. For example, in 1970, a tariff duty of 20% was levied on the c.i.f. (cost, insurance, and freight) price of a "small" automobile (Volkswagen size) import. The commodity tax rate of 15% was applied to the total imported price (c.i.f. plus the tariff duty) of the automobile, resulting in a combined rate of 38% of the c.i.f. price. In contrast, for a "large automobile (full-sized U.S. makes), a tariff rate of 17.5% and a commodity tax rate of 40% were applied, resulting in a combined rate of 64.5%.[16]

The third reason for the high prices of imported consumer goods in Japan is the inefficient system of merchandise distribution. A can of peaches costing 26¢ at the pier will eventually cost 52¢ to the consumer. Customs and handling charges at the pier add 9¢ to the imported price. The importer, several layers of wholesalers, and the retailer add the rest.[17] This cumbersome distribution system has its roots in the socio-economic conditions in Japan. The average Japanese housewife shops every day at several retail outlets within 500 yards of her home. She typically spends about yen 1,000 (a little over $3) each time. In large urban areas like Tokyo, the retail outlets are "midget stores tucked away on narrow streets." These neighborhood stores are served by a regional wholesaler, who is in turn supplied by a central wholesaler, and so on. They form tight, personal relationships with each other, and any attempt by a foreign supplier to bypass this distributive network will meet a hostile resistance. Such an inefficient distribution system constitutes a serious barrier to imports, since imported goods must naturally pass through a larger number of distribution channels than competing domestic goods. Moreover, the markups on imported goods are likely to be relatively higher than those on domestic goods because the wholesalers take back unsold domestic goods more readily than they do imported returnables because of their greater familiarity with domestic products and producers.[18]

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[16] *Chuo Koron, Keiei Mondai* (Central Review, Management Problems), Winter 1970, p. 85. In contrast, in 1970 the U.S. tariff rate on imported automobiles was 4.5%; combined with the federal excise tax rate of 7%, the total rate was 11.8%.

[17] *Wall Street Journal*, May 2, 1972.

[18] American-style supermarkets are not yet practical in Japan because of the relatively scant use of automobiles, scarcity of store parking space, and smallness of refrigerator space in the home.

Since the factors affecting the income elasticities of Japan's exports and imports are largely structural in nature and as such could not be eradicated overnight, it must be concluded that the income elasticity disparity cannot be eliminated quickly and that the structural bias toward expanding trade surplus will remain for some time to come.

Prospects for A Solution of Japan's Trade Problem

The Japanese officialdom and business establishment had perceived, until very recently, the problem of Japan's external economic relations primarily as a balance-of-payments problem. In their view, the so-called "external pressures *(gaiatsu)*" for yen revaluations have been exerted on Japan primarily because of Japan's huge payments surplus. This implies that the pressures could be averted by eliminating their cause, namely, the large payments surplus. The series of "yen defense programs" announced (but not implemented earnestly) during the last two years consisted largely of measures designed to reduce the payments surplus.

Although the December 1971 revaluation and the other yen-defense measures have been ineffective in reducing Japan's export surplus, Japan's efforts to increase capital and aid outflows have had some significant results. The sum total of public and private (direct and portfolio) investments and aid-giving for 1972 was close to $5 billion, which represented a substantial increase from the 1970-1971 average of $1.5 billion. Thus, from the point of view of payments balance alone, Japan can be said to be making a satisfactory progress toward restoring equilibrium.

Of course from the point of view of the international trade and payments theory, neither a balance in trade with a specific nation nor a balance in the trade account alone is required. Unfortunately, Japan's problem is no longer purely economic, but largely political, and as such the $4.2 billion surplus in the U.S.-Japanese trade is an anathema. Let us now turn to an examination of the factors that have direct bearing on the trade surplus.

The Japanese Government has progressively "liberalized" imports during the last decade.[19] The number of products whose imports are quantitatively restricted has decreased from 492 in 1962 to the present level of 33. Now 97% of the items on the Brussels Tariff Nomenclature are free of quantitative restrictions, which percentage compares favorably with those of other leading trading nations. Of the 33 items that are still controlled, 25 are agricultural products (cereals, dairy products, fruits, etc.) and the rest are manufactured products. The farm lobby and the Ministry of Agriculture firmly oppose any further liberalization of the agricultural products.

The Ministry of International Trade and Industry (MITI), on the other hand, is a staunch defender of the residual quotas on the eight manufactured products including computers, leather goods, and coal products. It con-

[19] In the official Japanese jargon, "import liberalization" refers narrowly to a reduction in the number of products on the list of imports that are subject to quantitative restrictions.

siders the existing quotas as a bare minimum requirement for the survival of the industries concerned.

Thus, further liberalization of the majority of the 33 product lines still under control is highly unlikely in the foreseeable future. Even if they were decontrolled, their impact on Japan's trade surplus would be minimal. It is noteworthy that of the $10 billion increase in the annual rate of Japan's imports since the import liberalization program was launched in 1960, only about $500 million is directly attributed to liberalization.[20] Similarly, the Japanese Government estimates that if all of the import quotas on agricultural imports were abolished, Japan's imports of these products would rise by $500 million per year, $100 million of which would be from the U.S.[21]

Nor would further reduction in tariff rates be likely to narrow Japan's trade imbalance markedly in the short run. The tariff rates on imports of producers' goods are already very low, and the volume of imports of these goods depends not so much on their prices as the level of economic activities in Japan. The rates on consumer goods are high, but their reduction is not likely to lower the relatively high prices of imported consumer goods in Japan owing to the various reasons discussed above.

Unlike imports, exports can be reduced quickly by revaluation, direct export control, or export tax. In an October 1972 meeting, the Japanese Government decided to apply a mild form of quantitative control over exports. It announced its intention to invoke the Export Trade Control Ordinance on export lines that are deemed increasing at an alarming rate. The ordinance had previously been used to control exports to Communist bloc countries under the COCOM agreement. Under this ordinance, a product line would be put on the list of exports subject to licensing by the MITI. On December 5, 1972, the government decided to apply the ordinance to the following four product lines—passenger cars, trucks, automotive chassis, and motor cycles—effective as of January 1, 1973. The list was extended in January 1973 to include seven more items—radios, tape recorders, stereo sets, electrical home appliances, lenses, still cameras, and 8-mm movie cameras.[22]

It is doubtful if the ordinance will be effective in drastically reducing Japan's trade surplus. Since the exports of most product lines are increasing rapidly, the ordinance, to be effective, will have to be applied to a great number of product lines and in a highly restrictive manner. A strong objection from the business community can be expected in such a case. For the government to administer the control program effectively, close cooperation with the business community is essential. Without such cooperation, setting up of reasonably acceptable ceilings on a great variety of product lines will be very difficult, and the ceilings that are not acceptable to the industries concerned will probably not be observed. The present mood of

[20] *Shukan Posto* (Weekly Post), April 23, 1970, p. 154.
[21] Radio Japan news broadcast on February 28, 1973.
[22] *Bank of Tokyo Weekly Review*, December 11, 1972 and January 29, 1973.

Japan's business leaders is hostile to the ordinance. They ask why they must bear the additional burden of a quantitative export control when they are already heavily handicaped by recent yen revaluations.

Prior to the October 1972 meeting, the Ministry of Finance had proposed an across-the-board 10% export tax. The proposal fell through in the face of a strong opposition by the MITI which preferred the use of the Export Trade Control Ordinance. Interestingly, the main objection to the export tax was based on the belief that the export tax would have a similar effect as that of a yen revaluation, and therefore might lead to a revaluation by making it psychologically more readily acceptable. Indeed the effect of an export tax would be very much like that of a revaluation. It would hurt Japan's export industries by lowering their output and profits. Its disadvantages as compared to a revaluation are that (1) it does not lower import prices, and (2) it would be costlier and more cumbersome to administer than a revaluation. That the export tax does not lower import prices means that it does not help slow down the inflation and that it does not improve Japan's terms of trade as much as revaluation. On the other hand, the export tax would be superior to a direct export control in that the former is less cumbersome to administer than the latter.

It thus appears that Japan's best chance for quickly and drastically reducing its trade surplus is yen revaluation. It affects all industries evenly, and it will be practically costless to administer. Its effect does not depend on the slow process of structural changes. It has an added benefit of slowing down Japan's inflation and improving the well-being of the people by improving the overall terms of trade. It affects the trade balance primarily through its effect on Japan's exports which have high price elasticities of demand. It may also have the desirable effect of lowering the income elasticity of demand for Japanese exports. Furthermore, revaluations, by lessening the degrees of undervaluation of the yen and overvaluation of the dollar, would make an increasing number of American products more competitive in the Japanese markets. The superiority of revaluation to any other methods is thus clear. It enables both Japan and the U.S. to reduce their trade imbalances while increasing their export of products in which they have genuine comparative advantage. Other methods—such as an export control or export taxes—tend to suppress exports of both countries, resulting in the diminution of the gains from international specialization.

Considering these obvious advantages of yen revaluation, one finds it difficult to understand the intensity of the widespread aversion to revaluation in Japan. It may be suspected that this aversion is a product of the prevailing philosophy of producerism that has characterized the Japanese society for decades. Under this philosophy, a revaluation is necessarily evil since it hurts the output and profits of some producers. That consumers as a whole would gain is conveniently ignored. Once such a view is promulgated, the Japanese public and press are easily swayed by the emotional appeal without objectively evaluating the relative merits and demerits of revaluation. At any rate, the intensity of the anti-revaluation sentiment in Japan reveals the deep-rooted fear of Japan's government and industrial leaders concerning the effectiveness of revaluation in reducing Japan's export surplus.

Exactly how much revaluation would be needed to effect a quick and drastic reduction in Japan's trade surplus within a short period of time—say a year? Although it is very difficult to predict accurately the degree of upvaluation needed, the following points may be borne in mind in estimating the needed extent of revaluation. First, in the short run, the structural and institutional factors can be assumed unchanged. This would put the burden of adjustment squarely on the exchange and the price effect working through relative price elasticities. Secondly, because of the oversized trade and payments surpluses and the resultant huge accumulation of international reserves (estimated to range between $25 and $30 billion), Japan need not be oversensitive to erring on the side of too much revaluation. If the trade and/or payments balances ever turn negative, Japan would have ample time to tide over the deficits. Thirdly, although the recent floating rate of yen 260 or so to the dollar may appear to represent sizable revaluations of the yen (about 35% since August 1971 and about 18% since December 1971), its actual impact on Japan's export may not be very significant. Throughout 1972 the market rate of exchange hovered around yen 290 to the dollar instead of the official parity of yen 308. Moreover, prior to the February 1973 crisis, many of Japanese firms had been settling their export accounts at arbitrary rates ranging from yen 270 to yen 280 to the dollar in anticipation of the second revaluation. If they were able to raise Japan's trade surplus in 1972 at these rates, then they would certainly find little difficulty in continuing to export at the yen 260 rate.

In order to directly attack the trade imbalance by revaluations and achieve a semblance of balance within a year or so, a rather substantial degree of revaluation, say to yen 200 or yen 220 to the dollar, would probably be necessary. The chances for such a drastic action now are remote. Whatever the Japanese Government has done in the past years, it has been done under one important constraint—not to compromise the interests of Japanese producers. Import liberalization and free access to Japanese markets by foreign capital have been strongly resisted because they might hurt some domestic producers. Revaluations have been resisted because they hurt some export industries. Since any policy measures that would help reduce Japan's trade surplus are likely to be substantive measures that would badly injure some interest groups, they are not likely to be initiated spontaneously and carried out in earnest. Within the framework of "Japan, Inc." the government cannot and will not take actions that might seriously hurt the business community because government and business are one and the same.

A sudden and drastic revaluation of the yen will also cause havoc in the Japanese economy. Many small firms in the traditional sector of the economy would go under, and many of the more efficient, larger firms in the modern sector would suffer reduction in output and profit. Temporarily at least, a severe recession and unemployment would follow. It would be a political suicide for Prime Minister Tanaka to allow such a situation to develop. Tanaka's government is already under fire at home for bowing to U.S. monetary pressures. Its popularity is dwindling, and it would be unwise for the Nixon Administration to pressure Japan so impatiently as to bring about a downfall of the conservative government. It may be safe to conclude, therefore, that a dissipation of Japan's trade surplus with the U.S. within a short period of time is technically feasible but its practical chances are very slim.

In contrast to the pessimistic short-run outlook, the prospects for dissolution of Japan's trade imbalance in the medium run—that is, over the next three to five years—are bright. There are two powerful forces working inexorably in the right direction. The first is the continued U.S. pressures on Japan in an effort to recover the prestige of the dollar and regain the competitiveness of U.S. exports. In the unlikely event that the Japanese government fails to adopt effective measures to reduce the imbalance, the surging protectionist sentiment in the U.S. would force Washington to take an increasingly tougher stand against Japan, threatening to start a "trade war" utilizing as weapons tariff surcharges and import quotas selectively applied against Japan. Such a development would presage a new era of world-wide protectionism and economic isolation which would hurt Japan much more than the U.S. Realizing this, Tokyo would grudgingly move in the right direction by making a series of small changes whose combined effect over a period of years would be substantial. These measures would include further revaluations of the yen, further opening up of the Japanese markets to foreign investments, further relaxation of tariff and non-tariff trade barriers including a reform of the commodity-tax structure, and further liberalization of quantitative import restrictions.

The second force that is at work toward a steady erosion of Japan's trade surplus is the inflation in the Japanese economy. The Japanese are now undertaking a vast restructuring of the entire economy. The objective of the ambitious effort which the Japanese call "remodeling of the Japanese Archipelago" is to disperse factories to the countryside and build dozens of new towns linked by networks of superhighways and express railways. This gigantic project, requiring an estimated investment of $1 trillion in public and private funds, is just one aspect of the massive efforts of the Japanese to shift priorities from export-led industrial super-growth to development of social capital and social services. Such heavy domestic investments, combined with the excessive supply of money caused by external surpluses, the rapidly rising wage rate caused by the acute labor shortage, and the increasingly stringent anti-pollution requirements that will inevitably raise production costs, make a sharp rise in Japanese prices inescapable. In fact, Japan's wholesale prices rose by 8% in 1972, as contrasted to the 1.1% rate of increase for the 1968-1971 period. Higher wholesale prices will sooner or later be translated into higher export prices, causing a slowdown and an eventual decline of Japan's export growth.

These two forces—the external force compelling further liberalization of imports and further upvaluation of the yen and the internal force working through inflation—are the consequences of the oversized trade surplus itself. They will work inexorably toward reducing the surplus as long as the surplus exists.

The Japanese have two alternatives at this crucial juncture. The first is to rely on the working of these two forces and take no positive action toward a solution of the problem. This is an extension of the path they have followed thus far. The trade surplus would diminish slowly. At home, the Japanese people would suffer from a vicious inflation. The discontented voters might turn to the Socialists and the Communists in large numbers forcing the conservatives out of power. Internationally, Japan would be criticized increasingly by its trading partners for its lack of sensibility and good faith. Protectionists in these countries would gain strength, international tension would intensify, and Japan's isolation would deepen.

The second alternative open to Japan is for it to make serious and earnest efforts to reduce its trade surplus by implementing genuine liberalization of trade and capital flows and by further revaluing the yen. The trade surplus would dissipate fairly quickly. Domestically, resources would be shifted from exports to badly needed social services, inflation would be curbed, and the process of rationalizing the Japanese economy would be accelerated. Externally, Japan's efforts to maintain a harmonious relationship with the rest of the world would have a better chance of success as the international tension caused by Japan's disruption of world markets tends to diminish.

Which alternative path will the Japanese take? Unfortunately, there is every reason to believe that they will have to do it the hard way. The Japanese business circles are keenly aware of the need for quickly reducing Japan's trade surplus, but each individual firm or industry vehemently opposes any measures that would compromise its interest in any way. Interfirm rivalry drives each firm to outperform others in export sales. The government is incapable of implementing a policy that might seriously injure some segments of "Japan, Inc." This philosophy of producerism, combined with the tendency of Japan's officialdom to venture into nothing unless there are precedents, and to procrastinate and to muddle along until it is finally forced by circumstances to make a desperate move, would make an autonomous solution of the trade-imbalance problem highly unlikely.

KANJI HAITANI is Associate Professor of Economics at the State University of New York, Fredonia.