

## Some Observations on the Japanese-American Economic Relations

### Introduction

I take it for granted that good political relations and friendly cooperation between Japan and the U.S. are in the interest of both countries and essential for world peace. Fortunately there exist no longer in the political field any conflicting aspirations or interests between the two countries. From time to time there may occur differences of opinion concerning certain problems and approaches to their solution. There may be misunderstandings about procedures. But since there are no clashes of vital interest of a political nature between the two countries, difference of opinion and misunderstanding as do occur can and will be quickly resolved by frank discussion.

In the economic area the situation is more complicated. There have been serious divergences of opinion in the field of international monetary arrangements and commercial policy, and there are conflicts of interest of special groups such as the Japanese and American textile, steel, automobile and other industries. Before commenting on these specific problems I should like to make my general position with respect to international trade and payments clear. As a free trader in principle, a conviction which I share with most economists, I am convinced that there are no basic economic clashes of interest between the two countries. Freer trade and payments, free competition and investment would serve the general interest of all countries. In the short run free imports often hurt special groups of producers. But most economists agree that the economy as a whole, the great mass of consumers are bound to gain more in the long run than special groups may lose in the short run.

This is not to deny that massive, rapid changes, say a sudden removal of all restrictions, could cause serious troubles of adjustment and widespread unemployment. Removal of restrictions should therefore be gradual and reciprocal. But experience has shown a hundred times that our modern free enterprise economies are flexible and can absorb quickly even large shifts and changes in demand. Examples of such shifts on a much larger scale than would be implied by trade liberalization are the quick and smooth adjustment of the economies of the two countries from peace to war and again from a war to peace footing.

A striking example of the capacity of modern capitalist economies to absorb even large structural changes in the area of international trade is the smooth and rapid adjustment of the economies of the six member countries of the European Common Market to the rapid removal of tariffs between them. When the process started fourteen years ago there was much apprehension that the economically weaker members of the community may suffer from the competition of the more efficient industries of Germany. But tariffs were removed ahead of schedule, trade between the members rose rapidly, competition increased, efficiency was enhanced, and the difficulties of adjustment were conspicuous by their absence. (On the possible damage done by certain policies of the European Common Market to outsiders such as Japan and the U.S., I shall say a few words later).

So much about the general background. I now turn to some of the specific problems.

### International Monetary Arrangements: The Yen and the Dollar

Last summer Japan and the U.S. disagreed sharply on the appropriate international value of the yen. Not only the American government, but most economic experts in the U.S. and also in Europe, were of the opinion that the yen was greatly undervalued and ought to be appreciated or allowed to float up. Heavy pressure was put on the Japanese government to act. The U.S. imposed an import surcharge of 10% on dutiable imports. Fortunately the surcharge was removed after the currency realignment was accomplished on December 18, 1971.

I myself, while sharing the view that the yen was (and probably still is) undervalued, have on several occasions argued that from the American standpoint there should be no objection against any country accumulating dollars. If Japan or Germany accumulate dollar balances, in other words accept dollars instead of real goods as payment for part of their exports to the U.S., it is their business and America should be happy with the bargain. The help of larger imports in the fight against inflation should not be overlooked. It is a mercantilist fallacy to believe that you are better off the more you export and the less you import.

The American government, however, did not accept this reasoning, mainly on the ground that the accumulation of dollars abroad implies larger imports into the U.S. and smaller exports from the U.S. Concretely the accumulation of dollars by Japan means larger Japanese exports of automobiles, textiles, steel, etc. impinging on particular American industries and thereby fostering American protectionist sentiments. I argued that the part of Japanese exports that can be attributed to the accumulation of dollars by Japan (undervaluation of the yen) is really quite small. After all the Japanese export surplus is a fraction of total exports and a tiny fraction of U.S. imports. Moreover, Japanese encroachment on particular American markets (textiles, etc.) has been going on for a long time, long before accumulation of dollars became a problem.<sup>1</sup> But the sudden sharp deterioration of the American trade balance late in 1970 and throughout 1971 resulting from an upsurge of imports of manufactured goods frightened the American government. This development in conjunction with the persistent unemployment, rising protectionist pressure and the ensuing speculative outflow of dollars forced the American government to take drastic steps.

I would argue that if the American government had not forced a realignment of parities by formally declaring the dollar inconvertible into gold — *de facto* it was inconvertible already before August 15 at least for large drawings — and by imposing a surcharge on imports, the large surplus countries surely would have taken measures to stop the flow of dollars. The German

<sup>1</sup> For details see GOTTFRIED HABERLER and THOMAS WILLETT, *A Strategy for U.S. Balance of Payments Policy*, American Enterprise Institute, Washington, D.C., 1970 and GOTTFRIED HABERLER, "U.S. Balance of Payments Policy and the International Monetary System". Essays in honor of R. Kamnitz to be published later in 1972 in *Convertibility, Multilateralism and Freedom*, ed. by Wolfgang Schmitz, Vienna and New York, Julius Springer, publishers.

mark was already floating up and Japan would hardly have accepted unlimited amounts of dollars. But without strong American pressure Japan and the other countries which eventually accepted an appreciation of their currencies in terms of the dollar would probably have delayed action.

Thus, looking back even observers who were shocked by the American action of August 15, 1971, will probably admit that the realignment of parities, forced by the American action, was necessary and in the interest of the world at large. (Whether it was sufficient only the future will tell).

While my advice to the *American* Government is to take a tolerant view if other countries accumulate dollars because such accumulation — barring precipitous, large changes and assuming that American internal policies are rationally conducted — benefits and does not hurt American economic interests, I would strongly advise the *Japanese* Government not to pursue a policy that leads to further accumulation of dollar balances but rather work towards a moderate reduction of the swollen reserves.

There are two basic reasons for this advice. First, it is generally recognized that Japan is well supplied or rather oversupplied with international reserves, so that any further increase would be a clear waste of resources, which could be much more productively invested at home. Second, rightly or wrongly, Japanese surpluses play into the hands of American and other countries' protectionists.

When assessing the adequacy of Japan's international reserves one has, of course, to distinguish between those accruals that stem from short term, largely speculative, capital flows and those that are the result of surpluses on current and trade account. Sometimes the expressions "borrowed" and "earned" or "gross" and "net" reserves are used. But without going into well-known facts and figures, it is generally admitted that earned, net reserves are fully adequate.

Let me now briefly discuss two related questions: First, could cessation of reserve growth or a reduction of reserves have an adverse effect on the economy? Second, what measures could be taken to check the growth of reserves or bring about a reduction? By changes in reserves I shall now refer to net, earned reserves, unless otherwise stated. In other words, only those reserve changes are considered that correspond to a deficit or surplus in the current balance. Concretely reserve reductions resulting from hot money

outflows will not be considered. [In a fuller treatment the question would have to be raised whether the so-called basic balance (current balance plus long term capital flows) is more relevant than the current balance. But for my purposes I need not go into such refinements].

### Possible Adverse Effects of a Decumulation of Reserves

In the short run a decumulation of dollar reserves (or even a sharp drop in their rate of growth) due to a "deterioration" of the current balance could have depressing effects. In fact, talking to Japanese experts, I got the impression that the American surcharge and the appreciation of the yen, by reducing the volume of or profits from exports, actually did somewhat intensify the recession from which the Japanese economy has been suffering for sometime.<sup>2</sup> But such deflationary tendencies can be effectively counteracted by appropriate monetary and fiscal measures. The Japanese economy has shown great resilience and flexibility which on many occasions have enabled it quickly to pull out of recessions. One factor contributing to this resilience and responsiveness to monetary and fiscal measures are the favorable labor-management relations in Japanese industries. As I understand it, absence of industry-wide collective bargaining and the fact that workers receive part of their income in the form of bonuses which depend on the profitability of the firms, lead to a prompt and significant reduction of labor cost in case of recession. In my opinion these conditions, much more favorable than in other industrial countries, explain, at least to a great extent, why the Japanese economy is able to quickly regain equilibrium after a recession and to snap back to full employment. So much about the short run impact of a cessation of reserve growth.

In the long run the Japanese economy surely does not require for its continuing growth the artificial stimulant of a large excess of exports over imports. We need not here go into the controversial question whether inflationary pressure is conducive to economic growth. Even if the answer were in the affirmative — which I

<sup>2</sup> In the second of the two above mentioned papers, I did point out that in the short run such an effect could possibly have an unfavorable impact on the U.S. balance of payments by reducing Japan's import demand.

doubt — any required inflationary stimulation could be provided by appropriate internal monetary-fiscal policies.

My conclusion then is that no lasting adverse effect need be expected to result from a cessation of dollar reserve accumulation or from a decumulation of reserves due to a "deterioration" of the trade or current balance.

### Methods to Stop Reserve Accumulation

How to bring about the desired change in the trade or current balance which will put a stop to the dollar accumulation?

Direct controls and restrictions of capital flows are no more than a palliative, dealing as they do merely with symptoms and not with the underlying conditions. Such measures, to the extent that they are effective, could prevent the inflow of speculative funds — interpreting this term in a broad sense so as to include the so-called "leads and lags" and shifts of balances of multinational corporations and the like. They will, thus, operate on what I called "gross" or "borrowed" reserves, but would hardly influence the trend of *net* reserves.

To correct a surplus in the trade and current account and thereby to influence the net reserve position, there exist three possible methods: (1) liberalization of imports by reducing tariffs or eliminating quotas (and other impediments to imports) and abolishing existing open or disguised export subsidies. (2) Appreciation or floating of the currency. (3) Sufficiently expansionary monetary and fiscal policies. (For completeness a fourth method may be mentioned — direct control of current transactions. But I shall not further consider this method. In case of a surplus such controls would have to be negative; that is to say import-stimulating and export-impeding. They are unpopular and would in reality amount to no more than a disguised, inefficient and wasteful appreciation of the currency. The latter is true also of the methods of splitting the exchange market and of dual or multiple exchange rates which are now so popular in Europe).

On general grounds the first method, trade liberalization, would be the most desirable one because it reduces not only the surplus but also corrects distortions in the pattern of trade thereby

increasing the efficiency of the economy. Politically it may however be difficult and it has the disadvantage that it is a once-for-all shot.

Appreciation of the currency, too, is a once-for-all method. It also has the disadvantage that one cannot be sure how large an appreciation is necessary to restore equilibrium. The consequence is that an appreciation is liable to be too small. If it were too large the surplus would be turned into a deficit, an outcome which policy makers will want most anxiously to avoid. Therefore, policy makers will be only prudent if they make the appreciation too small rather than too large. If the exchange rate is to be changed, floating is the better method.

Sufficiently expansionary monetary-fiscal policies have the disadvantage that they may require rising prices (inflation). In terms of consumer prices Japan, over the years, had more inflation than the United States. This somewhat paradoxical phenomenon that the U.S. was said to "export inflation" (through its balance of payments deficit) at a time when it did not have inflation (1958-1965), is explained by the fact that in Japan export prices, for one reason or the other, have been rising less than the consumer price level while in the U.S. the opposite has been the case.

Assuming — hopefully — that the U.S. will be able in the future to curb its inflation, my guess would be that not much inflation will be required in Japan to prevent further dollar accumulations. But Japan, as well as other possible surplus countries, will have to make a choice as to the method which she prefers — trade liberalization, currency appreciation or floating, or monetary expansion. The Germans seem to be more sensitive to inflation, the Japanese to appreciation and floating. Let me add that the U.S. should make the choice easier for other countries by bringing its inflation under control. Needless to say that this is in America's own interest.

Some people would say that the U.S. should make another contribution, namely to depreciate the dollar (in terms of gold or SDRs) when needed. To my mind this would make sense only in the unlikely case that the dollar was overvalued *vis-à-vis* the majority of currencies. So long as the dollar is the foremost reserve and intervention currency, and so long as gold plays a role in minds of many people it would not be in the interest of the world economy to tamper with the dollar price of gold. But no specific American interests are involved and it should be clearly understood, as Dr. Os-

sola recently pointed out that "it is incorrect to equate a devaluation of the dollar [in terms of gold] with the contribution of the U.S. to the burden of adjustment". ("Reflections on New Currency Solutions", in this *Review*, March 1972, p. 66, footnote 1.)

### Convertibility of the Dollar

Ever since the Smithsonian accord on the realignment of parities of December 18, 1971, the U.S. has been urged by the Europeans — not or not so much by the Japanese — to take steps to make the dollar again convertible. It should be observed, however, that the word "convertibility" has two meanings. In the current discussion *asset* convertibility is demanded, that is to say convertibility into some reserve asset, gold, SDRs or some new type of reserve asset. The other type of convertibility is what I should like to call *market* convertibility. In that latter sense the dollar has always been and still is freely and fully convertible — namely in the sense that everybody, foreigners as well as Americans, can use their dollars freely and without restrictions to buy or invest in the U.S., to withdraw investments and to convert dollars into any other currency in the exchange market at the prevailing market price (exchange rate). There exist some restrictions on convertibility of dollars into foreign currencies for Americans as far as investments abroad are concerned. I am referring to the so-called interest equalization tax (on the purchase of foreign securities by Americans), to mandatory restrictions of direct investment abroad by American corporations and the so-called "voluntary" restraints on lending abroad by American banks. Foreign holders of dollars, including foreign central banks, are however entirely free to convert their dollars in the exchange markets.

It is full and unconditional convertibility that matters. Almost all currencies are convertible in a more or less restricted fashion, some only via black markets. The dollar, German mark, Swiss franc and a few others enjoy full convertibility. It will be recalled that during the 1950s the problem of convertibility was widely debated. It was market convertibility that was at issue. The U.S. pressed for convertibility while the British government, after the premature and abortive dash for convertibility in 1947, for a long time resisted. In the late fifties and early sixties many countries

made their currencies more or less convertible (accepted Article VIII of the Bretton Woods Charter).<sup>3</sup>

It is full market convertibility that is important for the smooth operation and growth of world trade. This convertibility can be preserved even when a currency is allowed to float. Thus the Canadian dollar has been fully convertible all along during the period when it was allowed to float — 1950-1962 and again since June 1970. And the German mark was fully convertible when it was allowed to float (October 1969 and May to December 1971). Japan in the past has never asked for conversion of dollars into gold. She evidently was interested in market convertibility and not in convertibility into reserve assets.

It would lead too far here to discuss the convertibility problem exhaustively. Let me simply say this: There seems to be general agreement that convertibility into gold is out forever. Convertibility into SDRs or some new type of reserve assets (still to be created) would require a major overhaul of the international monetary system. There exist many blueprints for such a reconstruction. One of the best-known and best-thought-out is the "reserve settlement" system with the "composite reserve units" ("CRU's") proposed by Edward M. Bernstein.

It will, however, take a long time before such a reconstruction of the international monetary system can be agreed upon and be put into effect. In the meantime, it is of the utmost importance to keep the dollar convertible in the market sense. This is fully compatible with changes in exchange rates or with floating rates as the examples of several countries demonstrate. It is, however, incompatible with split exchange markets, dual or multiple exchange rates, and other types of exchange control which have become popular in Europe.

It would be most desirable if Japan and the U.S. and other like-minded countries could cooperate, in the interest of world trade and world welfare, to preserve the free market convertibility and usability of the dollar. With over fifty billion liquid dollar balances in the hands of central banks and many additional billions of liquid dollar balances held by private individuals, banks and

<sup>3</sup> It is a blemish of the Charter that it does not require full convertibility, but allows restrictions on capital transactions. Effective controls of capital transactions necessitate, in practice, controls of all transactions.

corporations, the dollar is still by far the most important reserve currency, official intervention and private transactions ("vehicle") currency. A market-convertible dollar is indispensable for the smooth working and growth of world trade.<sup>4</sup>

### Trade Problems

A smoothly functioning international monetary system is not an ultimate objective of economic policy but a means to facilitate the international exchange of goods and services which in turn is a condition for maximizing GNP and ultimately economic welfare of all participating countries. Free convertibility of all currencies in the market sense (absence of exchange control) is a necessary and, indeed, an indispensable condition for optimal international division of labor and growth of world trade. But it is not a sufficient condition. The missing condition is freedom of trade from tariffs, quotas and other restrictions.<sup>5</sup>

Neither Japan nor the U.S. pursue a policy of free trade. Both countries have import tariffs, quotas and a host of other restrictions on trade. I need not discuss which country has the higher tariff wall and the more restrictive system of quotas and other barriers to trade. Each has at times scolded the other for pursuing protectionist policies and both would greatly benefit from

<sup>4</sup> Let me add a technical footnote on convertibility. In connection with the operations of the International Monetary Fund a problem has arisen which is sometimes called the problem of "mini-convertibility" of the dollar. It is this: The Articles of Agreement of the IMF prohibit acceptance through repurchase by the Fund of any currency of which the Fund already holds 75% of the quota of the country in question. This limit has been reached for the dollar. The consequence is that Great Britain which has borrowed heavily from the Fund and would like to repay its debt ("repurchase its own currency from the Fund") cannot use dollars for that purpose. I cannot take the time to discuss this technicality any further. Suffice it to say that it is a minor hitch which should not be difficult to remove. To call it "mini-convertibility of the dollar" is clearly a misnomer. [Since this was written the problem of enabling Great Britain to repay its debt to the IMF has been solved to everybody's satisfaction.]

<sup>5</sup> It is true that in the last analysis commercial policy and exchange control are potentially perfect substitutes. This implies that any system of tariffs, quotas and subsidies is translatable into an equivalent system of exchange control with multiple exchange rates and *vice versa*. But it does not follow that the conventional distinction between the two policy areas is unimportant. For foreign economic policy is never sufficiently centralized and rational, nor are policy makers sufficiently knowledgeable and sophisticated to assure a fully consistent use of the two arsenals of instruments, exchange control and commercial policy.

a mutual reduction of trade barriers. (I personally would go a step further and argue that each would benefit from a unilateral reduction of barriers. But I realize that neither one would accept that advice and mutual reduction is, of course, better than a unilateral one).

Protectionist tendencies are running high in the U.S. at the present time. Thus organized labor, which in the past has been on the whole moderate with respect to protection (at least as far as the leaders at the top of the labor movement are concerned), has joined the protectionist camp. The reasons for this regrettable change are complex. One is that organized labor has become a small minority of the whole working population, but is well entrenched in manufacturing industries which are exposed to foreign, including Japanese, competition. Considerable unemployment is, as it always was, a factor that strengthens protectionist tendencies. And as mentioned, the sudden deterioration of the trade balance in 1970-71 has played into the hands of the protectionists.

Each of the two governments have again and again expressed their desire to reduce trade barriers and have rejected, in principle (although not always in practice), a policy of economic protection and economic isolationism. And each can help the other to hold the line against protectionist pressures by making concessions, by reducing tariffs and other impediments to trade.

It should be kept in mind that there obviously exists a certain asymmetry. The Japanese economy is the much more open one of the two; Japan's economy depends to a much greater extent on international trade than the American economy does. American merchandise imports and exports are each below 5% of GNP; the Japanese figure is more than double the American. (But these global figures understate the difference in the degree of dependence on international trade).

Elimination of the undervaluation of the yen and reduction of the excessively large Japanese trade balance will help the U.S. government to resist protectionist pressures. As pointed out earlier such a change would be in the general economic interest of Japan herself because the real resources now invested in oversized dollar balances could be utilized much more productively in Japan, for example in the fight against pollution and preservation of the environment. Japanese expert opinion seems to be in broad agree-

ment with these propositions. But it is understandable that export industries take a different position.

On the American side the interests of the economy as a whole, especially the welfare of the consumer — and everybody is after all a consumer — has been all too often sacrificed to the interests of small special groups of producers. The general interest is hurt by import restrictions, be they tariffs or quotas or so-called "voluntary" restrictions imposed in foreign exporters. "Voluntary" restrictions are even worse than ordinary quotas because they force foreign exporters to organize themselves in cartels for the monopolistic exploitation of the consumers in the importing country. Moreover, under that system the quota profits from imports go to the foreign exporter rather than to the public treasury of the importing country as under import tariffs or to the domestic importers under the usual quota system.

It would be unrealistic, however, to expect a rapid change in these policies, a sudden wholesale dismantling of import restrictions. All we can hope for is a gradual reduction of trade barriers on the basis of reciprocity. General trade negotiations, a sort of continuation or repetition of the "Kennedy round", have already been scheduled to be started next year. It is to be hoped that when the negotiations get under way the economic environment will be one of expansion. For experience has shown that recession periods marked by high unemployment are unpropitious for reducing trade barriers. It stands to reason that when general demand is brisk, the economy expands and labor is in scarce supply, it is easier to bring about the shifts in production and employment that are necessary to take advantage of the greater opportunities to trade which are provided by the reduction of trade barriers.

The two countries, Japan and the U.S., have many other common interests in the area of trade policy. Neither has joined an exclusive trade bloc or common market. And both have suffered from discriminatory policies on the part of existing trading blocs. Again Japan, because of the openness of her economy is much more vulnerable to discrimination than the U.S. Japan's international trade is geographically widely diversified. Her exports go to all continents and corners of the world. She fits into no regional grouping. Japan has therefore a vital interest in the preservation of the principle of non-discrimination as laid down in the General Agreement on Tariffs and Trade (GATT). No exclusive trading

bloc, short of one that embraces substantially the whole Western world, could adequately serve and preserve Japan's legitimate economic interests. Preservation, as far as possible, of the principle of non-discrimination and upholding of the principle of unconditional most favored nation treatment, as laid down in the GATT rules, has been for a long time a major objective of American international economic policy.

It is greatly to be hoped that Japan and the U.S. will work together and exercise joint leadership in the coming negotiations. A promising move in that direction, which would find much support in other countries, would be to promote a radical liberalization of imports of manufactured goods from less developed countries. Japan has already implemented a preferential tariff scheme in favor of developing countries, on August 1, 1971. The present American administration has gone on record to open the American market (with some exceptions) to imports of manufactured goods from less developed countries. But no progress has been made to get the matter through Congress. The U.S. should promptly follow the Japanese example and the two governments could jointly take the initiative to offer to enlarge these concessions and to extend them gradually to other industrial countries on a reciprocal basis. This would give a strong impetus to the movement towards freer trade.

Agricultural protection will be a more difficult nut to crack. And the problem of non-tariff barriers should not be forgotten.<sup>6</sup>

*Washington*

GOTTFRIED HABERLER

---

<sup>6</sup> On this see especially the excellent study by Professor KIYOSHI KOIJMA, *Non-Tariff Barriers to Japan's Trade*, under the auspices of the Japan Economic Research Center, Tokyo, 1971, and Professor ROBERT E. BALDWIN, *Non-Tariff Distortions of International Trade*, London and Washington, D.C., 1971.