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THE JAPANESE MARKET: HOW OPEN IS IT?

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JOINT ECONOMIC COMMITTEE
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WEDNESDAY, OCTOBER 11, 1989

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room 2253, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Obey, Scheuer, Solarz, Wylie, Snowe, and Upton.

Also present: Joseph J. Minarik, executive director; David R. Malpass, minority staff director; and Lee Price, Chad Stone, and Carl Delfeld, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. This morning the Joint Economic Committee will take up the question of "The Japanese Market: How Open Is It?"

Japan has lowered its official tariff and quota barriers as low as those of other industrial nations, and some have claimed that more barriers lay just behind them.

This hearing will attempt to provide a broad overview of the barriers that remain, how extensive are they, how much have they been reduced in recent years, what industries are most affected, and other questions.

We are fortunate today to have three experts on Japanese trade: Mr. Raymond Ahearn is a Specialist in Trade Relations at the Congressional Research Service. Mr. Robert Lawrence is a senior fellow at the Brookings Institution, and Mr. Clyde Prestowitz is a senior associate at the Carnegie Endowment for International Peace.

Gentlemen, we are happy to have you. Your prepared statements, of course, will be entered into the record in full and we'll begin the testimony.

Mr. Prestowitz, do you want to begin, and we'll just move across the table in that manner.

STATEMENT OF CLYDE PRESTOWITZ, SENIOR ASSOCIATE, CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

Mr. PRESTOWITZ. Thank you very much, Mr. Chairman.

I do not have a prepared statement.

The question of the openness or the closedness of the Japanese market is one that has been debated intensely for the last 8 years and really for the last 75 years.

I think the key question is not so much whether the Japanese market is open or closed, but the key question is what do we mean by open and what do we mean by closed. This is a topic to which we never direct our attention. We send our trade negotiators abroad to negotiate for open markets, but we never really tell them exactly what we mean by open.

In the commonly accepted American parlance, the Japanese market is not an open market, and there is both statistical and anecdotal evidence for this. Let me just cite a couple of recent statistics. You recall that the dollar has dropped precipitously since 1985, going from a peak of about 268 yen to the dollar to a bottom of close to 120.

Japanese export prices since 1985 have dropped 21 percent while Japanese domestic wholesale prices have dropped only 8.1 percent. Now all the rules of neoclassical economics tell us that when a country has a currency that doubles in relative value, its export prices ought to go up. But Japanese export prices have not gone up.

Moreover, if we look at the Japanese wholesale prices compared to Japanese consumer prices, domestic consumer prices have held steady while wholesale prices have enjoyed the benefit of the falling dollar. Consequently, it's obvious that the benefit of the falling dollar is being caught in the chain of middlemen in Japan.

There is other statistical evidence to indicate that the Japanese market is not open in the American sense of the term, and I think Bob Lawrence probably will address himself to that.

Let me cite a couple of other points.

In the early 1980's, I was engaged in negotiation to open the Japanese telecommunications market, particularly for optical fiber cable. That is an area that has been investigated and placed under great scrutiny for the past 6 or 7 years, and I think there is no question among technical experts that the optical fiber cable made by Corning Glass and its joint venture partner Siemens and Siecor is as good as or better than any optical fiber cable in the world, and it is considerably less expensive than optical fiber cable made in Japan. Despite a halving of the value of the dollar, U.S. optical fiber cable sales in Japan have climbed only marginally.

I spoke recently with the head of Siecor's operations in Japan, who is an old acquaintance of mine, and he also is an expert on the Japanese market. His name is Mr. Baskerville. He has been in Japan for over 25 years. He initially was a missionary to Japan. He speaks absolutely fluent Japanese.

For a number of years he headed up the operations of Weyerhauser Corp. in Japan, and was very successful in taking Weyerhauser's sales over the billion dollar mark in Japan selling pulp and paper and logs.

A few years ago he left Weyerhauser and joined Siecor to promote the sales of optical fiber cable, and he told me quite frankly that on his bids he is offering cable to municipalities, to government bodies, to large electric power companies, and he is told by those to whom he is offering his product that his share of the bid will be *x* percent, and he is told that he cannot go above a certain percentage of the bids because to do so would endanger the health of the Japanese optical fiber cable market.

Now, I just cite this one case, but I think we have seen similar experiences in the area of supercomputers, a telecommunications network, telecommunications equipment, and a range of other products.

Whenever we cite these anecdotes and whenever we cite these statistics, we in the United States tend to draw a conclusion, and the conclusion is that, one, the Japanese market is closed, two, Japan is unfair, and three, that therefore we need to pressure Japan to change these procedures or these methods of doing business, and ultimately we get ourselves into the position where we say if Japan doesn't change, we will have to consider retaliation.

This brings me back to the point I wanted to start with, and that is what do we mean by open and what do we mean by closed.

You just pointed out that Japan's tariff levels are lower than those on average of most of the industrial OECD countries, and you pointed out that Japan has actually fewer quotas than we do or than EC does. The Japanese think their market is open, and in formal GATT terms it is. In the terms of classic trade barriers the Japanese market is open.

So the question then becomes what impedes and what makes it difficult to get into the Japanese market, and the answer is a myriad of structural, policy, and social practices.

I think it's very important to understand that when we tell the Japanese to open, we are in effect trying to impose on them a mode of social and political organization, which may or may not be compatible with them.

Sony recently acquired Columbia Studios, the biggest acquisition of an American company by a Japanese company. It made headlines. It was the cover story of Newsweek magazine last week. At the press conference in Japan at which that acquisition was announced foreign reporters were barred. The press conference was open only to Japanese.

In a society where it is common to open that kind of a press conference only to Japanese reporters, does it seem likely that that kind of a society is going to have what we think of as an open market? The Japanese were shocked when American reporters objected that they were being barred from the press conference. It just didn't occur to them that this is something in which American reporters should be included.

Now, I want to emphasize that I am not saying that Japan is unfair. I am not leveling any accusation at Sony. I am not saying that Sony was unfair. I am just trying to point out that this kind of natural way of operating in Japan is not what we think of as open.

Or let me say it a different way. Several years ago I had a conversation with Kazuo Inamori, the chairman of Kyocera. Kyocera is a company that dominates the world market for ceramic packages that are used to package semiconductor chips. The Pentagon could not make a Minuteman missile without Kyocera. The B-1 would not fly without Kyocera.

I spoke to Kazuo Inamori, who founded this company about the founding of the company. Now today Inamori is a man of 52 or 53. He is a billionaire several times over. But when he started his company he was a total unknown. He did not go to Tokyo University. He wasn't born in Tokyo. He was born in Kagoshima, which is about as far away from Tokyo as you can get and still be in Japan. He wasn't tied up with the Mitsui Bank or the Mitsubishi keiretsu or any of the major power centers in Japan.

He told me how hard it was to get his business going. He said that there was not venture capital. Banks wouldn't touch him. Suppliers would only supply him on a c.o.d. basis and, worst of all, customers wouldn't buy. And he said, "Prestowitzsan, I don't speak English very well but," he said, "I flew to Dallas, Texas, and I visited Texas Instruments." And he said, "I was amazed. TI didn't ask me who my bank was, what keiretsu I was a member of, what university I went to or who my family was." He said, "they just asked to see my product, and they liked it, and they gave me an order." Then he said, "as my business with TI grew, then I began to do business with some Japanese companies."

But I'll never forget the comment he made to me. He said, "you know, Prestowitzsan, the Japanese market is not closed to foreigners. It's closed to Japanese, to newcomers."

I repeated that same story to Akio Morita, the chairman of Sony, and he said, "yes, that's just like Sony. We get our start in the American market."

I repeated it to executives of Honda Motors, and they said, "oh, yes," they said, "the U.S. market is much easier for us. We sell many more cars in the United States then we do in Japan."

Now all three of those companies are newcomers in Japan. They are not part of the Japanese establishment, and all three of them have had great difficulty in establishing themselves in Japan. In the United States we think of Akio Morita as a captain of Japanese industry. In Japan he is not seen as the major player that we think of him over here because Sony is not the major company in Japan that it is in the United States.

Now my point is again not to say that Japan is unfair and not to lambaste Japan, but to suggest that what we mean by open is something that the Japanese simply don't understand, and that is not surprising it seems to me.

We are an immigrant country. In an immigrant country you have to do business on the basis of the best offer. If you don't and if you deal with people on the basis of relationships, you won't have newcomers and you won't be an immigrant country. But Japan is not an immigrant country. It's a traditional country.

In the United States if I have been doing business with Bob for 20 years and you offer me a 10-percent price break, I'm perfectly justified in switching to you. In fact, if I don't switch to you, you might sue me for discrimination. I would be considered unfair.

In Japan if I switch, that's considered unfair because I have abandoned my long-term loyal supplier, the guy who stuck with me through thick and thin, who maybe even owns shares of my business.

The point is not that the Japanese practice of loyalty and long-term relationships is unfair, but it's not open in the American sense of the term. And there is a flip side to this, and the flip side is the Japanese always accuse us of not trying hard enough. Now we don't understand "try hard" any more than the Japanese understand "open."

I used to run a company that made artifical kidneys in Japan. The customers for kidneys are doctors. In Japan doctors have such a high social status that by law they don't pay taxes. Now my poor, lowly salesmen had to sell kidneys to these gods of doctors. If a doctor wanted his car washed on a Sunday afternoon, my salesman went and washed his car. If a doctor took a vacation trip to Las Vegas, my salesman went and carried his bags. I even had the experience once of a doctor going to New York City. He had not been there before. He had heard that New York is dangerous, a lot of muggings and so forth, and he asked my salesman to go with him and to sleep in the hallway in front of his hotel door at night to guard the door. Now that is a "trying hard" that Americans are never going to do.

When we tell the Japanese to open, what we are really saying is be like us, and when they tell us to try hard, what they are really saying is be like us. And we have two guys here standing on a corner saying you be like me, no you be like me. That's what this whole discussion of open is about.

I suggest, Mr. Chairman, it's a useless discussion, and we ought to forget about whether Japan is open or not. I was a U.S. trade negotiator for 5½ years, and I can tell you that I cannot negotiate open. Anything concrete that you can identify I can negotiate. Give me a price you want, give me a market share, give me a sliding scale and give me an absolute amount. Anything that you can tell me what you want that is concrete and identifiable, I can negotiate. I can't negotiate "open" and I can't negotiate "try hard" because nobody knows what they mean and you don't know when you have them.

I would really sincerely like to suggest that you use your committee, this opportunity as an opportunity to move the United States and Japan off of this sterile, hopeless, deadend debate and begin talking about how we operate together to maintain mutually beneficial trade without the corrosion of our relationship that arises from this insistence on an American style openness.

Thank you very much.

Representative HAMILTON. Thank you, Mr. Prestowitz.

Mr. Lawrence, please proceed.

STATEMENT OF ROBERT Z. LAWRENCE, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. LAWRENCE. Thank you very much, Mr. Chairman.

Well, Mr. Prestowitz has outlined very lucidly and depicted for us the problems of trying to negotiate to open the Japanese market in terms of rules when apparently the Japanese don't interpret the rules in the same way as we do.

And, indeed, he represents a voice, a growing voice in the United States which argues that our traditional way of dealing with the Japanese, which has been traditionally to negotiate about the rules of the game, is simply inappropriate. Therefore, what it's argued we ought to do is to begin to negotiate about results. The new rising slogan is let's deal with results rather than rules.

Now I happen to be someone who does believe that there are significant barriers to sales in the Japanese marketplace. At the same time I'm very skeptical that a negotiation over results is going to lead to a Japan of the kind that we the United States would like to see.

I think it's generally agreed by most Americans that this form of managed trade is not desirable for us, but some are arguing we have no alternative because the alternative is simply to continue what we're doing, and allegedly what we are doing has simply not seen any positive results at all.

So what I would like to do in my testimony is in fact think about whether we ought to be as exasperated, as many Americans are, whether we ought to say that there has been no shift within Japan, little evidence of meaningful change and therefore that we ought to move to this new posture of demanding results.

Before we do that, however, I think it is critical to realize that when you talk about negotiation over results it's very important to be clear on what kind of results you are seeking, and before you talk about those results, you also have to know what your objectives are.

I would suggest that when you get down into concrete terms, people talking about an open market really have to make one critical distinction to start off with. Are we talking about a market that is open to our firms or are we talking about a market that is open to imports or foreign products? These are not the same thing.

A market, for instance, if you look at one example of managed trade, which we already have before us, that is the United States-Japan semiconductor agreement. It's a very interesting document. Actually you can get hold of that side letter which is in dispute. But, nonetheless, what that side letter contained, to my understanding, is a commitment by the Japanese to try to raise the sales, and this is critical, of foreign-owned semiconductor manufacturers to 20 percent of the Japanese marketplace.

Now that's a very interesting conception of open. Notice, that agreement did not call for an increase in imports. It called for the increase in sales of foreign-owned companies. That is a corporate perspective, if you will, on openness. So let's think about it.

If Texas Instruments builds semiconductors in Japan using Japanese workers, that's OK. That meets that agreement. If Texas Instruments builds them in Korea, that meets that agreement. On the other hand, if Fujitsu makes semiconductors in the United States, that does not qualify.

Now we had better think about what our objectives are. If you happen to believe that what is critical for instance is the U.S. industrial base, that is to say the base located in the United States, clearly this is not an agreement which meets that need. In fact, I would submit what you have is clear evidence of the way in which a managed trade arrangement negotiating about the results, which has to be very, very precise, can often be captured by the corporate interest.

Indeed, it is another interesting example, and it was pointed out by Bob Reich in his piece in "The New Republic," and that is our negotiations in the area of cellular telephones.

Now believe you me, I'm not against opening the market for American firms either, but nonetheless it is striking that we've been negotiating with the Japanese to open up the cellular telephone marketplace for our firms and, as Reich points out, where are the cellular telephones manufactured? In Malaysia. Where are they designed? In Malaysia.

So what I would submit is when you start to move to a managed trade posture, you have to be very clear about what you want. If you're interested in enhancing the profits of U.S. companies, then you will negotiate one kind of agreement. If, on the other hand, say you're concerned about the jobs available for American workers, the spillovers that occur as a result of high-tech activities in the U.S. economy, you'll negotiate another kind of agreement.

Many are demanding that what we should tell the Japanese is that they should increase their imports. We should set some quantitative target. Rudy Dornbusch from MIT says we should demand that they import 15 percent annual growth rates from the United States over a 10-year period.

Well, let's think of that one. What about imports from the foreign affiliates of Japanese companies, do those qualify as imports? Sure they do. Would they improve the trade balance? Perhaps they do. Is that what we really want to induce? Would a managed trade approach which emphasized imports really satisfy the U.S. objectives?

So I would suggest that Mr. Prestowitz has laid out an important question for us, but when you start to get into the details of a managed trade negotiation, you start to realize that before you can decide on results you have to decide on objectives.

Now I personally still believe that the desirable objective is in fact to make the Japanese market a contestable one. That is to say, to try to remove the barriers that inhibit the free entry of foreign products and firms. That's to me the objective we should try to strive to achieve.

Now if we actually look at the Japanese market, what kind of evidence do we see? Is it in fact closed or is it open? Well, there are various data. What I do in my prepared statement is to try to bring out some of that evidence. The novel part of this prepared statement actually is to point out the unusual degree to which Japanese firms control Japanese international trade.

In table 1, of my prepared statement, I bring out the fact that typically when the United States exports to Europe, some 36 or 37 percent of our exports are shipped directly by U.S. companies, and when Europe exports to the United States, about 29.8 percent of the products are shipped by European companies to the United States.

In 1986, when the United States exported to Japan, 58 percent of the products were shipped by the foreign affiliates of Japanese companies. Japanese companies located in the United States shipped about 60 percent of what we consider to be American exports. By contrast, 13.6 percent of the exports to Japan, of American exports to Japan were directly shipped from a U.S. multinational parent in the United States back to the Japanese marketplace.

So what you have here is very dramatic evidence of the degree to which intrafirm characterize Japanese trade and the degree to which those firms are Japanese, and I discuss that whole aspect in my prepared statement.

Another area where economists have debated the question of openness lies in the volume of imports into Japan and in a lot of statistical studies, and I won't get into them in great detail. I conducted some statistical experiments finding that the Japanese import levels were unusually low, particularly of manufactured goods. Others have done some studies and they find different results.

I think in fact we have been concentrating as economists too much on the question of quantities and in fact not enough on the issue of prices, because while you may need an intricate statistical model in order to compute whether the Japanese are importing more than they should or less than they should, the price evidence is much more direct.

And what is so striking about the price evidence is that it does show that in general goods which we think are tradeable are inordinately expensive in Japan.

Now to say that they are expensive in Japan, of course, is to immediately open a whole can of worms because if the goods sold in a store are expensive, it could be that it's simply expensive to deliver them to the consumer. One aspect is the distribution margins. If it turns out real estate is expensive in Tokyo, after all, shouldn't you expect that prices will be higher in Tokyo?

Well, what I have tried to do is to use a technique of input/output analysis in fact to extract the part of the costs that is due to the distribution of the products. Let's take out those margins and then compare the prices of the products.

And what I find is, interestingly enough, that distribution margins in the United States, to my surprise, are somewhat lower than they are in Japan for goods in general, but not much lower. That implies that since the prices are higher to the consumers, and in fact the prices of Japanese goods are typically higher when they leave the factory. It is the manufacturers in Japan who are charging different prices, higher prices to Japanese consumers for the same goods that they sell in the rest of the world.

This is a critical fact actually because a lot of people believe that what we have to do is to make their distribution system more efficient, and if the margins are quite similar in Japan and in the United States, then maybe it isn't the efficiency of the distribution system we should be concentrating on. In fact, I believe it's to a much greater degree the fact that within that distribution system manufacturers have immense power over the prices which the final retailers charge for their products.

We have to think through whether a strategy of changing the distribution system will change that fact. Many people think the salvation lies in more large stores. We hear that all the time. But if you go into large stores in Japan and you buy a Panasonic piece of equipment, you will discover that the price is the same for that equipment generally as you would pay in other stores in Japan. True, the large store may get some kind of a kickback if its volume is larger, but, nonetheless, the price will be expensive. So I think the price evidence is very significant.

Another aspect of the price evidence that I just touch on here is the fact that it does appear that imported products, on the other hand, are subject to much higher margins, and indeed very interesting studies have now been done by the Economic Planning Agency in Japan itself.

In November 1988, they did a survey. They took brand names in 11 categories. They looked at handbags, fountain pens, and golf clubs and they compared the cost of these in 41 Japanese cities and then they looked at the prices in New York, Paris, and Dusseldorf. What they discovered is typically in New York these products were 38 percent less expensive than they were in these Japanese cities, not only in Tokyo, and they were 30 percent cheaper in Paris and Dusseldorf.

So we clearly, if we look at that price evidence, we have dramatic evidence, in my judgment, that the Japanese are able to price discriminate to a high degree. They can charge high prices in the domestic market for the goods they sell. They can, as Clyde Prestowitz indicated earlier, they can lower and have changes in their export prices, which are different from the prices in the domestic marketplace.

All of this, in my judgment, presents a compelling picture that something is stopping people from what we economists call arbitrage, buying where the prices are lower and selling where the prices are higher. There has to be something preventing that process.

Anyway, that's the picture of Japan, and I think the argument is that there remain barriers.

But just let me turn finally to the question of adjustment. I happen to believe that if you actually look at the data both of what has happened to the shipments as controlled by U.S. firms, the shipments controlled by Japanese firms and the total volume of imports going into Japan, you see signs of dramatic change.

In my prepared statement there is a chart which shows the shares shipped by Japanese firms of U.S. exports going back to Japan. This was around 70 percent in the early 1980's——

Representative HAMILTON. What table is that, Mr. Lawrence?

Mr. LAWRENCE. I'm sorry, it's a chart at the back.

Representative HAMILTON. Table——

Mr. LAWRENCE. It's not a table. It's not labeled, unfortunately.

Representative HAMILTON. Oh, I see it.

Mr. LAWRENCE. That has gone down from around 70 percent through 1985 to just under 40 percent in 1987. So we do see a diminishing share of U.S. exports being shipped by Japanese firms. It's still high, but it's declining.

If we actually look at the share being shipped directly by U.S. companies, which is in my prepared statement in table 6 under the column of "Exports in Japan," there we see the shares shipped by U.S. companies has increased from 11 percent in 1983 to 17.3 percent in 1987. So while we still find that U.S. companies are shipping an inordinately low share and we find Japanese companies are shipping a high share, we are seeing a process of change taking place.

If you look at the total volume of imports going into Japan and the volume of manufactured goods, you find that this is up 100 percent over a 4-year period.

Now I would submit respectfully that if we sat down and negotiated with Japan and we try to set a quantitative target for how much their imports should increase, we would never get them to agree to what has actually taken place in volume terms in the Japanese marketplace.

My own judgment is that while there are barriers in Japan, they operate much more like tariffs than they do like quotas. That is to say they keep prices high in Japan, but they do not necessarily stifle changes when the underlying costs do change.

If you have a tariff on a product, you just add a 30-percent markup. If that product goes down in price, then the domestic price will also go down. That means that people will tend to respond, and I think you do find that the Japanese marketplace has been responding to changes in the exchange rate.

I will just conclude by saying you also find that in areas where we have changed the rules there is evidence that they have increased their imports much faster than their imports in general.

Thank you.

Representative HAMILTON. Thank you, Mr. Lawrence.

[The prepared statement of Mr. Lawrence follows:]

PREPARED STATEMENT OF ROBERT Z. LAWRENCE*

Summary

Traditionally, U.S. policy has sought a more open Japanese market for foreign firms and products by negotiating rules which would remove barriers. But demands are growing for the United States to seek managed trade agreements which ensure results. Some results-oriented approaches might open the Japanese market in the sense of increasing the demand for U.S. products; others might increase the profits of U.S. firms; but they are unlikely to open the market in the crucial sense of making Japanese markets genuinely contestable by foreigners.

In opening Japan, attention must be played to Japanese corporate behavior. Japanese trade is distinctive because foreign exports to Japan have generally been shipped by the foreign affiliates of Japanese firms. This behavior results from unusual incentives that have induced Japanese firms to move downstream through international backward vertical integration. These same incentives have led to the unusually low share of intra-industry Japanese trade, or more precisely to the low share of imports and exports of different varieties of similar products.

There are large and persistent price differences between Japan and other industrial economies that cannot be accounted for by higher Japanese distribution margins or real estate costs. Japanese manufacturers charge higher prices for the goods they sell in Japan than for the goods they sell in the rest of the world. In 1987, goods prices in Japan were 87 percent higher than in the United States. Many imported products in Japan are, however, subject to unusually high markups. Potential arbitrage opportunities between the Japanese market and the rest of the world are thus not fully exploited.

Many of the barriers to the Japanese market operate like tariffs rather than quotas. They keep imported products expensive in Japan but they do not prevent marginal responses to price and cost incentives. The result has been a dramatic increase in the volume of manufactured goods imports into Japan over the past four years. While only preliminary data are available, it appears that the share of Japanese imports accounted for by the intra-firm shipments of Japanese-owned firms abroad has been declining. On the other hand, the intra-firm shipments of U.S. firms have been a growing share of U.S. exports to Japan. There is evidence that the sectoral approach to opening the Japanese market has been working although much remains to be done.

In the light of this evidence the Japanese market does not appear to be open, but there is also considerable evidence it is responding to price changes and sectoral negotiations.

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*The responsibility for this statement is mine alone and does not reflect the views of the Brookings Institution, its officers, trustees, or other staff members.

The Japanese Market: How Open Is It?

Few issues in International economics are more contentious than the allegedly closed nature of the Japanese market. In the early 1980s, the issue so vexed the European Community that it sought redress through the GATT. Similarly, over the years the United States has conducted an extensive set of bilateral negotiations to open the Japanese market for its firms and products ranging from beef to baseball bats. Generally, the U.S. focus has been on ensuring equal treatment for foreign firms and products through changes in rules and procedures. Currently the U.S. is delving even deeper into the structure of the Japanese economy in the so-called Structural Impediments Initiative.

Increasingly, however, there are calls for this negotiating stance to change. The new demand is that the U.S. should shift from equal opportunity to affirmative action. Some argue Japan will never play by Western rules. Indeed given the outstanding performance of the Japanese economy, the outside world has no right to demand that Japan change practices which have served it so well. Instead of trying to change Japan, the outside world should simply negotiate quantitative import targets and allow the Japanese government, which best understands its economic system, to ensure these are attained. The new slogan is therefore "results rather than rules."

Some are calling for targets for aggregate Japanese imports of manufactured goods from the United States.[1] Others advocate a more detailed sectoral approach to setting import levels. A report issued by ACTPN, a private sector advisory group to USTR Carla Hills has suggested the U.S. should require that the Japanese set quantitative import targets for specific commodities.

These new proposals are being advanced because it is felt that past U.S. policies simply have not worked. The Japanese economy is closed to foreign products and firms and fails to respond to market incentives like other countries. While advocates of a results-oriented approach to Japanese trade generally agree a managed trade system is not ideal, they suggest there is no other way to open the Japanese market.

In this testimony I will try to answer two questions. First, could these managed-trade approaches achieve an open market? Secondly, is the Japanese market closed and unresponsive to price changes and negotiations over rules?

An Open Market: What Does It Mean?

Before deciding if a results-oriented policy can open Japan, we need to decide what we mean by "open." One important distinction is between markets which are open to products and markets which are open to firms. In a world in which multinational corporations dominate trade, it is clearly inappropriate to think only of national production by national firms. Many approaches to market opening assume implicitly that trade occurs only through firms whose production location and firm nationality correspond.

1. Rudiger Dornbusch, "Is There a Case for Aggressive Bilateralism and How Best to Practice It?" paper prepared for the Brookings Institution Conference on Alternative Trade Strategies for the United States, September 12, 1989.

There is an important distinction between foreign products and foreign firms. Many of the intangible barriers in the Japanese market inhibit the sale of products made by foreign firms but they need not preclude imports of products manufactured by foreign subsidiaries of domestic firms. Ford and General Motors may not know how to make and sell an automobile that Japanese consumers will buy but Toyota and Honda surely do. Japanese firms already have an established reputation with their Japanese customers. They understand how to deal with unusual aspects of Japanese institutions and customs.

Policy initiatives which stress achieving a Japanese market which imports a given quantity of imports need not entail increased participation of foreign firms in the Japanese economy. Such proposals equate openness with higher import volumes. An increased demand by Japan for imports raises the demand for foreign labor, but it could be compatible with a continuation of the official and private practices which (a) make the Japanese market so difficult for foreigners to crack and (b) prevent Japanese consumers from enjoying the full benefits of access to cheaper imported products.

While such a results-oriented approach might raise the volume of Japanese trade, it could actually lead to a market with more rather than less government and corporate control. In fact, such an approach gives up on the idea the Japanese economy will ever be genuinely open. It settles for making sure that at least Japan buys a certain amount of imports as a *quid pro quo* for its exports. By insisting Japan implement such a system, the U.S. would severely limit Japan's ability to become a genuinely liberal economy. Sector-by-sector targets can only be enforced if the MITI (Ministry of Trade and Industry) is powerful enough to guide Japanese firm behavior in great detail. MITI would be forced to organize and monitor numerous buying cartels. Firms would be forced to collude on how imported products are to be handled. Instead of encouraging Japan in the liberal direction urged in its own official Maekawa report, the policies would be driving it back towards precisely the system the world finds so difficult in the first place.[2] Japanese firms would enhance their profits from buying cheaper foreign inputs and producing some products abroad but they could continue to exercise their power over domestic pricing and marketing practices.

On the other hand, barriers at the border against products made in other countries, do not necessarily hinder products made by foreign firms in Japan. It is usually assumed that there is an automatic and positive relationship between imports and the establishment of foreign firms in Japan. But there is no necessary linkage. If foreign-owned firms gain entry in Japan, particularly if import barriers remain, they may decide to produce more locally. Thus imports may actually decline rather than increase. A more "open" Japanese market for foreign firms need not lower the Japanese trade surplus or provide the benefits for foreign workers, foreign terms of trade and spillovers in foreign economies that many seem to expect.

The U.S.-Japan Semiconducter Agreement is an example of results-oriented trade policy. It is striking that the sideletter to the Semiconductor Trade Agreement (STA) negotiated between the United States and Japan called for the products of foreign-owned companies to achieve 20

2. The discussion presumes such a policy could actually be achieved. But in many sectors, given the nature of the barriers, it would be virtually impossible for the Japanese government in good faith to enforce such an agreement. In consumer goods or goods sold in markets with many firms the proposal is impractical. You can put goods on the shelves but you cannot make people buy them.

percent of the domestic sales by 1991. The semiconducters Texas Instruments produces in Japan or Korea, using Japanese workers qualify for this quota, the semiconducters NEC or Fujitsu produce in the United States using American workers do not. As it has been implemented, this initiative is certainly not designed to maximize its impact on the U.S. industrial base. Indeed it could be met by the supply of semiconductors from Japan-based foreign owned firms!

A second U.S. initiative also emphasizes corporate participation rather than the United States trade deficit or production structure. As Robert Reich has noted the major U.S. initiative to open the Tokyo market for cellular telephone sales by Motorola will increase the sales of telephones designed and manufactured in Malaysia.[3]

Of course, policies may legitimately reflect a variety of objectives. For some purposes, e.g., enhancing the welfare of U.S. workers, it may suffice to emphasize greater import volumes; for other purposes, e.g., enhancing the profits of U.S. firms, it may suffice to seek increased participation by U.S. firms in Japan. But these approaches should not be confused with policies which aim at maximizing global welfare by achieving a market that is open in the sense that it can be readily contested by new firms, both foreign and domestic, who chose to supply products made at home and abroad. Indeed as I have argued above, a managed trade arrangement could make such a market more difficult to achieve.

Finally, it should be stressed that although they are often justified in terms of their impact on the aggregate trade balance, there is no necessary relationship between the size of a nation's trade balance and the

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3. Robert B. Reich, "Members Only" The New Republic, June 26, 1989, pp. 14-18.

openness of its markets. West Germany, for example, has one of world's most open markets, but it often has a trade surplus which is a higher share of its GNP than Japan. In general a nation's trade balance in goods and services is a macroeconomic relationship which reflects in aggregate saving and investment behavior. While there are some channels by which changes in trade barriers may alter saving and investment behavior -- the linkages are subtle and unlikely to be robust. After surveying some of these arguments, Richard Clarida has recently concluded "the macroeconomic implications of opening foreign markets with Super 301 are likely to be negligible."[4]

Japanese Companies and Japanese Trade

Much of the theory of international trade ignores the role of corporations in the conduct of trade. Trade is presumed to take place in arms length transactions between buyers located in the importing country and sellers located in the exporting country. Yet, a remarkably high proportion of international trade occurs through intra-firm shipments. This institutional reality underscores the complementarity that frequently exists between foreign trade and direct foreign investment. There appear to be major benefits from international vertical integration.

It has been pointed out that Japanese has an unusually small amount of intra-industry trade. I have estimated for example that in 1980 an index of intra-industry trade for Japanese manufactured goods trade measured 30 compared with an average of 70 in other major industrial countries.[5] But what is perhaps less well appreciated about Japanese trade, however, is the

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4. Richard H. Clarida, "On the U.S. Trade Deficit, Protectionism and Policy Coordination," paper presented at Columbia University Conference on U.S. Trade Policy, September 8, 1989, p. 28.

5. Robert Z. Lawrence, "Imports in Japan: Closed Markets or Minds?" Brookings Papers on Economic Activity, 2:1987, p. 539.

large amount of Japanese intra-firm trade. Using Department of Commerce Surveys on the trade flows associated with U.S.-owned multinational companies (MNCs) and those with the Foreign Affiliates located in the United States we can put together the following picture: As Reported in Table 1, in 1986 intra-firm trade accounted for 48.5 percent of U.S. exports to Europe; and 42.0 percent of U.S. imports from Europe; But intra-firm shipments accounted for 75.0 percent of U.S. imports from Japan MNCs and 72 percent of U.S. exports to Japan.

A striking feature of these numbers is the unusual degree to which Japanese MNCs dominate Japanese imports. In U.S. and European exports to each other, the exporting country firms dominate the intra-firm sales. In 1986, intra-firm shipments of U.S. exporters accounted for 36.9 percent of U.S. exports to Europe while intra-firm shipments by European exporters account for 29.8 percent percent of EC exports to the United States. Similarly Japanese exports to the U.S. were dominated by the intra-firm shipments of Japanese exporting firms -- their share was 66.1 percent of all U.S. imports from Japan. This suggests typically the international vertical integration process moves upstream internationally from producers to their markets. Usually firms who develop a differentiated product in their home market discover they can exploit that advantage by selling it abroad.

The structure of Japanese imports is unusual because movements have typically been downstream. Intra-firm shipments from Japanese subsidiaries abroad to their parent companies dominate Japanese imports. In 1986, Japanese affiliates in the United States shipped 58.4 percent of all U.S. exports to Japan back to their Japanese parents. By contrast, U.S. affiliates in Japan, imported from their parent companies only 13.6 percent of all Japanese imports from the United States (see table 1).

One potential explanation for this unusual corporate involvement could be an unusual commodity composition of Japanese imports. But this does not explain the small direct U.S. company role. As reported in table 2, intra-firm shipments by U.S. companies in their trade with Japan are an unusually small share of U.S. exports to Japan in every major export category. Similarly, the kinds of imports Japan imports from the U.S. are not typically imported by parent firms in the importing country.

Firms with established positions in the Japanese market find it profitable to invest in production or purchasing entities abroad. Apparently the structure of the Japanese economy provides unusually strong incentives for downstream movement and results in Japan's international trade being conducted by _Japanese_ distributors.

When intra-firm shipments of imports are dominated by foreign firms, as they generally are, they are likely to reflect the importation of new product varieties. But intra-firm imports by _domestic_ firms are more likely to reflect domestic market imperfections. They are likely to involve shipments of inputs which are cheaper abroad or imports of varieties produced by the domestic firm which can be manufactured more cheaply abroad. Domestic firms are less likely to import directly, products which compete directly with those they (or their associates) manufacture at home. Intra-firm shipments by domestic firms are thus less likely to result in the importation of _new varieties_ produced abroad.

Trading Companies. The majority of intra-firm import shipments in Japan appear to be undertaken by general trading companies. As indicated in table 3, the Japanese affiliates reporting extensive shipments of U.S. exports to Japan are concentrated in, but not confined to wholesale trade -- particularly in farm products and metals and minerals. While trading companies are not unknown elsewhere, in no other country have they grown to the extent and size they have in Japan.

It is an error to view the trading companies only as purveyors of raw materials imports. They play a major role both as exporters and importers of a wide variety of manufactured goods. They have acted as agents for imports of Nuclear plants from Westinghouse and General Electric and aircraft from Boeing and Lockheed. In its business profile, the Nissho Iwai Trading Company notes, for example, that it serves as "the exclusive agent for the Boeing Aircraft Company for sales to airlines, McDonnel Douglas for military aircraft to Japan's self defense forces and DeHaviland for commuter aircraft."

It is also an error to view these companies simply as brokers or traders. They provide their customers with an extensive set of services, including information and intelligence, medium-term finance, shipping, warehousing and distribution. Their international and domestic equity relationships extend backwards into mining, agriculture, and manufacturing and forwards to retailers and shopping centers. The trading companies are firmly rooted in the domestic distribution system and they have complemented this position with extensive import distribution systems. These include huge complexes -- kombinatos -- for the unloading, warehousing and distribution of imported products such as food, chemicals and steel products.[6] These centers allow the efficient allocation of imports to upstream affiliates and independent customers.

The Japanese economy provides trading companies with major advantages as procurers for Japan. They are efficient providers of intermediation

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6. For a description, see Kojima Kiyoshi and Terutomo Ozawa, Japan's General Trading Companies: Merchants of Economic Development (Paris: OECD, 1984), p. 111.

services which are required by Japanese firms who engage in trade because of the cultural and geographic distance of Japan from its markets. In addition, however, their positions have been bolstered by policy and other practices. In particular, the companies have functioned as the buying and selling arms of industrial groups. The existence of entry barriers to selling in Japan implies that companies who have already sunk the costs in overcoming them have an inherent advantage as buyers of attractive foreign products.

Implications. The trading companies do appear willing, indeed eager, to encourage imports in cases where these are in the interests of domestic manufacturing firms. They have not only played a crucial role in providing raw materials for the economy but, according to Kojima and Ozawa, they have also been instrumental in persuading firms to locate abroad to serve the Japanese market when it appears production is no longer competitive. But given the importance of the trading companies in Japanese imports a key issue is their willingness to import products which compete directly with domestic firms with whom they have close relationships. This they appear less eager to do.

The role of Japanese companies in Japanese trade also has significant political implications. Not only are Japanese imports of manufactured goods low, but U.S. firms play an unusually small role in selling the products Japan does import. Since U.S. firms are generally more politically influential than foreign subsidiaries, Japanese influence in offsetting U.S. protectionist actions is even weaker than the low level of its imports would suggest.

Foreign Affiliates in Japan. While the intra-firm shipments to Japanese parents from their overseas affiliates are an unusually high share of Japanese imports, the shipments from foreign parents to Japanese affiliates are an unusually small share of foreign exports to Japan. In 1986, U.S. companies shipped 13.6 percent of all U.S. exports to Japan to their Japanese affiliates and just 9.7 percent of these exports to majority owned affiliates. In manufactured goods the U.S. company role is even smaller. In 1986, U.S. firms shipped just $947 million to their majority owned manufacturing affiliates in Japan (and $1.6 billion to all affiliates).

The total value of owners equity in U.S. majority owned affiliates in Japan amounted to $11.5 billion in 1987, of which just $6.4 billion was in manufacturing. Thus while there are U.S. companies which have successfully penetrated the Japanese market, they remain the exception rather than the rule. Despite the lifting of formal restrictions on inward direct foreign investment, foreign entry into Japan remains low compared with investment in other major industrial nations.

The result, therefore, is that U.S. exporters to Japan remain highly dependent on Japanese distributors for the sale of their products in Japan. This suggests the argument that the Japanese market is closed to imports needs to be modified. If foreign goods are directly competitive with domestic products they will have difficulty entering. If imports are complementary with the interests of domestic companies they will not. However, in most cases corporate control over the trade rests in Japanese hands.

Prices

In 1985, according to the OECD, imports accounted for 5.8 percent of Japanese expenditures on manufactured products. By contrast, they were 12.9

percent of U.S. expenditures. While it is clear that Japanese manufactured imports are low, the explanation for this level remains controversial. There is an extensive set of anecdotes on Japanese import barriers in specific sectors. But economists mistrust anecdotal evidence because it may be selectively biased (only the losers complain) and not subject to quantitative appraisals. They have therefore sought firmer evidence that barriers have had a significant impact on Japan's trade structure.

The problem is that factors other than trade barriers could, in principle, account for Japan's trade structure. While Japan may well have unusually extensive barriers to manufactured goods imports, its low level of imports is undoubtedly also influenced by its distance from its trading partners (physically and culturally) and its relatively poor endowments of natural resources.

Studies of Japan's trade structure have reached different conclusions. Saxonhouse (with the exception of several agricultural sectors), Leamer, Bergsten and Cline, Noland and Balassa and Noland have run tests which conclude that Japanese import levels are "normal" given the other attributes of its economy. Lawrence and Balassa and Noland, on the other hand, find evidence Japanese manufactured imports are unusually low.

It appears, however, that these empirical tests do not settle the issue. To provide a flawless test, it appears the barriers must be explicitly modelled. But this is rather difficult, when by their very nature they are "intangible" or even invisible.

<u>Prices</u>. But perhaps all the tests discussed above are not asking the most relevant question. They focus too much attention on the question of quantities, or trade structure and not enough on the question of prices. Perhaps the important question is not "does Japan import too little?" but

"are imports too expensive in Japan?" Before we descend into the knotty issues of national differences in taste and factor endowments it seems necessary to clear up the prior question of whether consumers in Japan are given the same choices. The direct observation of price behavior may be a more accurate measure of openness than tests of quantities which test on elaborate statistical models.

Actual trade flows may be low for fundamental economic reasons such as factor endowments and the competitiveness of Japanese products, but if the Japanese market is contestable, we should see the potential for entry keeping Japanese prices in line with those in other markets. If the same product sells for different prices in different locations, over long periods of time, however, it seems reasonable to infer the existence of barriers to arbitrage.

There is considerable evidence that the prices of goods are much higher in Japan than in most other countries. A useful summary measure of goods prices in general are the purchasing power parity estimates used by the OECD for deflating measures of inventories (of both consumer and producer goods). In 1985, by this indicator, goods prices in Japan were 25 percent higher in Japan than in the United States and 42 higher than in the European Community.[7]

Using wholesale prices as a measure, between 1985 and 1987 goods prices in Japan declined by 8.65 percent while they remained constant in the United States. Given the decline of the dollar from 200.5 yen in 1985 to an average of 123 yen in 1987, this implies, measured in U.S. dollars, goods prices in Japan in 1987 were 85.6 percent higher than in the United States.

7. OECD, Purchasing Power Parities and Real Expenditures 1985, Department of Economics and Statistics, (Paris: OECD, 1987).

But these comparisons at the retail level are plagued with problems. In particular, because distribution margins could in principle differ across countries. Assume for example, the Japanese distribution sector is extremely inefficient.[8] The market could be completely open, but both foreign and domestic could be subject to the same, extremely high costs of distribution. It could also be the case that the distribution system for these markets is highly competitive and mark-ups have to be more expensive in Japan because of higher real estate costs; Japanese retail prices could be higher but this would simply reflect the underlying economic costs of distribution. Moreover, in this case, making the distribution system more "efficient" -- through large stores and other changes in rules -- might improve Japanese living standards tremendously but do little to raise the level of imports.

I have therefore analyzed distribution margins using input-output tables in Japan and the United States. As reported in table 4, the payments by the retail and wholesale trade for indirect inputs in both countries are remarkably similar -- around a third of total output. Payments to the real estate sector are also a remarkably similar share. Overall as a share of total goods sales (Domestic absorption plus merchandise exports) value added in wholesale and retail trade the 25.6 percent in Japan in 1985 is remarkably similar to the margin in the USA in 1983. In 1987 the ratios for Japan and the United States were 26 and 24 percent respectively.[9]

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8. Ahearn has argued, for example, that the multi-tiered distribution system in Japan raises markups on goods. Raymond J. Ahearn, "Japan: Prospects for Greater Openness" (Library of Congress, Congressional Research Service, 1989).

9. For Japan, see National Income Accounts: Supply and Disposition of Commodities, Economic Planning Agency, Government of Japan, 1989, pp. 176 -77. For USA, see Survey of Current Business (U.S. Department of Commerce, July 1989).

If distribution margins are the same in Japan and the United States, but final goods prices are much higher in Japan, this suggests the high prices generally are being paid to producers rather than distributors. Indeed the different behavior of exports and domestic prices points to the capacity of producers for price discrimination. Apparently, they are able to maintain prices at levels which are higher in Japan than elsewhere. This confirms in aggregate, the anecdotal evidence, discovered by many Japanese tourists, of what James Fallows has called the 47th Street Photo phenomenon: Japanese goods cost less in other countries than they do in Japan.

The comparative data on profit rates in manufacturing, as calculated by the OECD, lend further support to the notion that Japanese manufacturers have considerable market power. According to Chan-Lee and Sutch, rates of return in Japanese manufacturing have typically been twice as high as those in the United States and other industrial countries.[10] Similarly the share of profits in value-added in Japanese manufacturing (44.0) percent in 1983 was much higher than in the United States (25 percent).

But while distribution margins on products, in Japan, in general appear similar to those in the United States, this does not hold for margins on imported products. As reported in a survey conducted by the Ministry of Trade and Industry, the prices of imported brand name goods in Japan are 30-60 percent higher than those in the USA and Europe. The study, conducted in November 1988, compared prices of products in 11 categories such as perfume, handbags, fountain pens and golf clubs in five overseas cities and 41 Japanese cities. The survey showed that prices in New York, Paris and Dusseldorf were 38, 29 and 27 percent lower than those in Tokyo.

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10. James H. Chan-Lee and Helen Sutch, "Profits and Rates of Return in OECD Countries," OECD Economics and Statistics Department, Working Paper no. 20, May 1985, p. 8.

Similarly, Ahearn cites a study by the Economic Planning Agency which found that in 1987 unregulated consumer goods (goods not subject to any restrictions in Japan) were 36 percent more expensive in Japan in 1987 than in New York. Consumer goods that were subject to restrictions in Japan (e.g., food, liquor and energy) were 92 percent more expensive.[11] Accordingly, it appears that some imported products in Japan are subject to higher markups than other Japanese products. In principle, in an open market over long periods of time, there should be major opportunities for arbitrage.

Adjustment

A major reason given for the adoption of dramatically new U.S. policies toward Japan is the assertion that the Japanese economy fails to respond to relative price changes. Support for this view is derived from the apparent lack of adjustment in the U.S.-Japan bilateral trade deficit -- measured in U.S. dollars. But it should be stressed that since the devaluation of the dollar has taken place from a position a substantial initial imbalance, the failure of the trade deficit to decline in dollars is not necessarily indicative of a lack of adjustment in Japan. If the U.S. import demand elasticity is close to unity, as it appears to be, measured in dollars imports from Japan will not be affected by changes in the exchange rate. This means that all of the decline in the Japanese surplus has to come from a rise in the value of U.S. exports to Japan. Since in 1985 U.S. exports to Japan (of $22.6 billion) were 31.3 percent of U.S. imports from Japan ($72.4 billion), exports have to grow over three times as fast as imports, simply to stay even. The fact that the nominal trade deficit has remained fairly

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11. Raymond J. Ahearn, "Japan: Prospects for Greater Openness."

constant, actually indicates a dramatic increase in the value of U.S. exports to Japan.

Indeed between 1985 and 1988, according to the U.S. Department of Commerce, U.S. exports to Japan increased from $22.6 billion to $37.7 billion dollars. Similarly U.S. manufactured goods imports increased from $12.3 billion to $22 billion -- a rise of 79 percent in a period of relative price stability. Over this same period, according to the Economic Planning Agency of Japan, the volume of Japanese imports increased by 39.4 percent, and the overall volume of Japanese imports of manufactured goods increased by 78.3 percent. By the first quarter of 1989, the volume of Japanese manufactured goods imports was 100 percent higher than in 1985.

In 1987 I wrote a paper which suggested that Japanese imports of manufactured goods were "unusually" low by about 40 percent <u>in 1980</u>. This number has now been subject to considerable abuse. Since the volume of Japanese manufactured imports has increased by over this amount since 1985, some have used this result to suggest that the levels of Japanese manufactured goods are now "normal."[12] But an application of the methodology I used in that paper would not endorse this conclusion. Since the study was cross-sectional it used nominal data measured in <u>domestic currencies</u>. In 1980, as measured by the OECD, imports accounted for 5.8 percent of Japanese expenditures on manufactured products. In 1985 they accounted for 5.3 percent. Using Japanese national income accounts data, I estimate on a similar basis the share in 1987 was actually 7.5 percent lower than in 1985. Measured on the OECD basis this would entail a share of roughly 4.9 percent.

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12. See, for example, Japan-U.S. Business Council, "Can a 'Results-Oriented' Trade Strategy Work? -- Critical Comments on the ACTPN Report," August 25, 1989.

The reason is that for purposes of this calculation the yen value of manufactured imports is relevant.

Nonetheless, as the Japanese trade data indicate, it would be inappropriate to argue, there has been no response in manufactured imports into Japan. In fact, measured in 1980 prices, data from the National Income Accounts suggests the share of imported manufactured goods products in Japan spending increased from 6.0 to 8.2 percent of domestic absorption.

In my 1987 paper, I also observed that imports into Japan were as responsive to relative price changes as imports in other industrial countries. I have recently estimated regressions which indicate the response in Japanese manufactured goods to the rise in the yen and the rapid expansion in domestic demand between 1985 and 1988 was actually somewhat faster than might have been expected on the basis of the historic relationship between imports, domestic demand and the real exchange rate.[13] An out-of-sample forecast of the volume of manufactured imports, given the actual behavior of domestic activity and relative prices underpredict the volume of manufactured imports in 1988 by between 9 and 18 percent.

Corporate Role. Judged by the volume of products being sold, the Japanese economy is becoming more open. But what about the corporate role? There is considerable anecdotal evidence that Japanese investment in foreign beef stockyards in the United States and Australia has increased in response to the anticipated opening of the beef market. Similarly, that Japanese investment in citrus orchards has increased in response to the potential in that market. But what do the aggregate data indicate?

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13. A similar conclusion is reached by Corker; see) Robert Corker, "External Adjustment and the Strong Yen," IMF Staff Papers, vol. 36 (June 1989), no. 2, pp. 464-93.

Unfortunately, the data that are available are limited. But they do suggest that the Japanese corporate role in Japanese imports is declining. As reported in table 5, in 1985 almost seventy percent of U.S. exports to Japan was shipped by a Japanese affiliate in the United States to its Japanese parent. In 1986 the share of Japanese affiliates was 58.4 percent and in 1987 the share was 39.6 percent. Between 1986 and 1987 U.S. exports to Japan increased from $26.9 billion to $28.2 billion. The decline in the share of U.S. exports shipped by Japanese foreign affiliates indicates that the dollar value of their sales actually declined quite considerably. The hold of the general trading companies appears to be slipping. And, indeed, there are reports of their seeking a variety of new business opportunities.[14] The trading companies role is particularly conspicuous, for it is being partially offset by a rising share of Japanese imports that are being shipped by the foreign affiliates of Japanese companies --so-called "reverse imports"

A trend in the opposite direction is apparent in the shipments of U.S. firms. As reported in table 6, the intra-firm trade from parents in the U.S. to their affiliates located in Japan has increased steadily, their share in U.S. exports has risen from 11.0 percent in 1983 to 14.8 percent in 1985 and 17.3 percent in 1987.

Finally, it is noteworthy that U.S. exports have surged in sectors in which negotiations to change the rules have been concluded. According to the ACTPN Report, after ten years of pressure, virtually all barriers to the importation of tobacco into Japan have fallen. The four sectors which were singled out for negotiation under the maligned Market Opening Sector

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14. For an account of these, see John Choy, "Japan's Sogo Sosha: Back to the Future?" Japan Economic Institute no. 34(a), September 2, 1988.

Specific (MOSS) talks in the mid-1980s have shown impressive growth in Japanese imports. According to the report, from 1985 to 1987, U.S. exports to Japan in the four product categories combined increased by 46.5 percent, well above the 24.8 percent increase in total U.S. exports to Japan over the same period. The report dismisses this performance because the total increase in exports of the products (of $1.3 billion) was small relative to the entire bilateral trade imbalance. But no one expected negotiations in a few sectors to turn the entire imbalance around. The problem, may not be the approach, i.e., emphasizing rules, but the limited resources and narrow focus of the number of sectors brought into consideration. We need not only tough, persistent negotiations, but enough patience to let the results begin to build.

Concluding Remarks

Several noteworthy features have emerged from the data: Three point to the role still left to play by the removal of barriers. (1) Imports continue to account for an unusually small share of Japanese expenditures on manufactured products. (2) Barriers continue to inhibit the international arbitrage of prices differences between Japan and other markets. And (3) the intra-firm shipments of Japanese firms continue to account for an unusually high share of Japanese imports.

But there are also signs that since 1985, the Japanese economy has made major adjustments. (1) The Japanese economy has undergone a major adjustment in response to the strengthening of the Yen. According to the Japanese EPA, in the first quarter of 1989, Japan imported twice the volume of manufactured goods it imported in 1985. (2) U.S. affiliates based in Japan are raising their share of U.S. exports and (3) The intra-firm shipments of Japanese trading companies has declined conspicuously. Those who claim exchange rates do not change Japanese buying patterns, have simply not examined the data.

In the light of this evidence, it is not surprising that the trade disputes between Japan and the United States about the closed nature of the Japanese market continue. But it is surprising, given the major shifts in Japanese behavior that have taken place over the past few years, that some Americans feel so exasperated that they are driven to advocate an entirely new approach which emphasizes results rather than rules. In fact, the evidence suggests the twin policies of a strong yen and detailed negotiations about results are working.

TABLE 1: INTRA-FIRM TRADE IN 1986

(percent)

	EUROPE				JAPAN			
UNITED STATES	Total	Foreign Affiliates to/from Foreign Parent	U.S. Aff. to/from US Parent	Of Which Majority Owned Aff.	Total	Foreign Affiliates to/from Foreign Parent	US Aff. to/from US Parent	Of Which Majority Owned Aff.
EXPORTS	48.5	11.6	36.9	32.8	72.0	58.4	13.6	9.7
IMPORTS	42.0	29.8	12.2	10.5	75.0	66.1	8.9	1.8

Source: U.S. Dept of Commerce

TABLE 2: PERCENTAGE OF TOTAL U.S. EXPORTS SHIPPED BY U.S. MULTINATIONAL TO THEIR FOREIGN AFFILIATES, BY COMMODITY IN 1986

	EC (12)	JAPAN	WORLD
Total	34.1	13.6	32.8
Petroleum	38.3	4.6	52.2
Total, Manufactures	25.4	9.4	28.4
Food and Kindred	13.7	0.2	6.3
Chemicals	36.3	13.9	25.0
Machinery, ex. elec.	22.4	19.0	14.4
Electric	40.6	24.9	52.3
Transportation	10.0	4.0	69.3
Other	45.3	12.2	30.6

SOURCE: U.S. DEPARTMENT OF COMMERCE

Table 3: U.S. Exports Shipped by Foreign Affiliates to Foreign Parent Groups in Japan in 1986 and 1987
(millions of dollars)

	1986	% of total exports to Foreign Parents	1987	% of total exports to Foreign Parents
All industries	22693		20838	
Manufacturing	906	4.0	1048	5.0
Primary & Fab. Metal	15	0.1	29	0.1
Machinery	276	1.2	307	1.5
Machinery,ex. elec	188	0.8	243	1.2
Electric	88	0.4	64	0.3
Other Man.	292	1.3	356	1.7
Wholesale Trade	21629	95.3	19673	94.4
Of which:				
Motor vehicles	---	---	---	---
Metals & Minerals	9697	42.7	10922	52.4
Other Durables	828	3.6	---	---
Farm Product Raw Materials	7872	34.7	4066	19.5
Electrical Goods	NA	NA	483	2.3
Machinery & eqpt.	NA	NA	368	1.8
Groceries	NA	NA	623	3.0

Source: U.S. Dept. of Commerce

Table 4: Wholesale and Retail Trade Margins

	JAPAN (1985) VALUE (trillion yen)	JAPAN (1985) SHARE	U.S. (1983) VALUE (billion $)	U.S. (1983) SHARE
INTERMEDIATE INPUTS	20.122	0.33	194.347	0.34
Of Which: Real Estate	2.815	0.046	27.609	0.048
VALUE ADDED	41.024	0.67	378.355	0.66
TOTAL OUTPUT	61.146		572.702	
FINAL SALES of GOODS (C+I+G+X)	160.052		1667	
W&Ret margin	0.256		0.227	
DIST MARGIN	0.38		0.34	

SOURCES: US Input-Output Table 1
Survey of Current Business
February 1989

US National Income Accocounts
Dept. of Commerce

Japan 1985 Input-Output Table
Economic Statistics Annual
March 1989

Annual Report on National Accounts
EPA 1989 page 174

TABLE 5: PERCENT OF U.S. MERCHANDISE EXPORTS AND IMPORTS SHIPPED BY AFFILIATES FOREIGN PARENT, COUNTRY AND INDUSTRY OF UBO BY TRANSACTOR, 1981 - 1987
(millions of dollars)

	EXPORTS			IMPORTS		
	EUROPEAN COMMUNITIES	JAPAN	WORLD	EUROPEAN COMMUNITIES	JAPAN	WORLD
1981	11.9	75.1	11.5	37.7	69.4	20.0
1982	16.1	65.5	11.8	37.1	71.4	21.3
1983	12.2	63.9	11.3	35.4	68.8	21.2
1984	15.0	66.9	12.4	30.8	67.7	21.6
1985	13.7	69.7	12.2	29.5	69.6	23.7
1986	11.6	58.4	11.6	29.8	66.1	25.4
1987	7.5	39.6	7.7	31.5	67.3	26.2

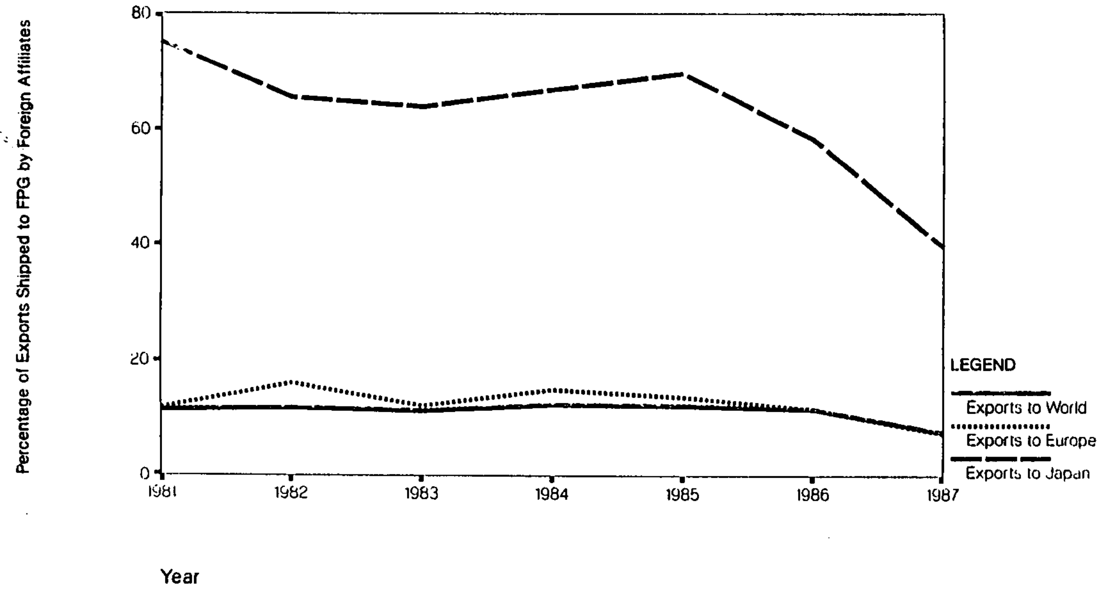
Source: U.S. Dept of Commerce

TABLE 6: PERCENTAGE OF U.S. EXPORTS AND IMPORTS WITH AFFILIATES OF U.S. MULTINATIONAL CORPORATIONS, BY AREA OF AFFILIATES, FOR 1983-1987

	EXPORTS			IMPORTS		
	EC (12)	JAPAN	WORLD	EC (12)	JAPAN	WORLD
1983	39.5	11.0	28.7	15.1	9.4	20.6
1984	38.2	12.3	30.4	13.7	7.2	19.2
1985	39.7	14.8	32.7	14.7	9.2	19.7
1986	36.9	13.6	32.8	12.2	8.9	17.7
1987	36.3	17.3	31.0	14.5	10.9	18.6

SOURCE: U.S. DEPARTMENT OF COMMERCE

Percentage of U.S. Exports Shipped by Foreign Affiliates to the Foreign Parent Group in 1981 - 1987



Source US Department of Commerce

Representative HAMILTON. Mr. Ahearn, please proceed.

STATEMENT OF RAYMOND J. AHEARN, SPECIALIST IN TRADE RELATIONS, FOREIGN AFFAIRS AND NATIONAL DEFENSE DIVISION, CONGRESSIONAL RESEARCH SERVICE

Mr. AHEARN. Mr. Chairman and members of the committee, it is with great pleasure that I appear before you today to testify on the Japanese market.

My statement assesses three categories of Japanese trade barriers. It examines the forces within Japan both for and against change, and evaluates the prospects for a more open market.

My conclusion is that the course of Japan's market opening reforms likely will continue to be incremental and uneven. This view is based on a recent CRS report I wrote at the request of Senator Roth. I will read a shortened version of my prepared statement and submit the full prepared statement for the record.

Japan has made progress over the past decade in removing traditional trade barriers, such as tariffs and quotas. But despite the progress made, numerous other impediments to trade associated with government regulations, exclusionary business practices, and Japanese attitudes remain.

There continuing impediments to trade impose economic costs on U.S. firms, enhance the competitiveness of Japanese competitors, and put stress on the overall United States/Japan relationship.

A great deal of controversy in United States/Japan trade relations revolves around the question of Japan's high prices. High domestic prices allow Japanese companies to earn substantial profits that can be used to subsidize both research and development and aggressive export drives.

If cheaper imports could freely enter Japan, Japan's high prices would be reduced to world levels and much of the controversy over Japan's closed market would end, but a variety of government practices and regulations restrain imports and keep prices high.

As Robert Lawrence has pointed out, there are barriers to arbitrage, which is implicit evidence that the market remains closed to some degree.

Agriculture tariffs and quotas, for example, are an important cause of high food prices. High prices in Japan are also related to government restrictions on distribution. The distribution system is dominated by small mom and pop shops. Unlike large department stores and supermarkets, these small shops tend not to carry imports, but the dominance of these shops is reinforced by regulations limiting the ability of large department stores and supermarkets to establish new stores.

Japan's very weak enforcement of antitrust laws also contributes to high prices and it allows Japanese firms to price discriminate. Japan's Fair Trade Commission remains primarily concerned about stability in markets and in preventing what the Japanese call competitive chaos.

Instead of restricting monopolies and other abuses of market power, the Japan's Fair Trade Commission tends to concentrate on regulating various kinds of sales promotions, such as coupons and service discounts. Exclusive practices in distribution and hundreds of legal cartels also tend to drive prices up substantially.

Exclusionary business practices are the second category of Japanese impediments to trade. The problem here lies in the organization of Japanese business and the tendency of companies to buy from longstanding Japanese suppliers.

Japan's industrial structure raises significant barriers to foreign producers trying to break into Japan's market for intermediate and capital goods in particular. U.S. exports of highly competitive machinery, electronic components, telecommunications equipment, and computers are most affected by these barriers.

Various economic groupings within Japan serve as a source of stable and preferential trading relationships. Business is fostered to the maximum extent within the family and a certain amount of willingness to pay above-market prices to help out one's group partners is expected. Intergroup dealings account for an estimated 20 to 30 percent of total sales for some group members.

This buying within the family orientation covers a wide spectrum of the Japanese manufacturing sector. It provides Japanese industry with a certain natural immunity to imports making official protection unnecessary because price is not the most important consideration.

One way to break through the system and to sell in Japan's producer goods markets is to establish a manufacturing facility in Japan. Now some U.S. companies have done this and have become part of the Japanese system and in turn have become very profitable.

In general, this requires a substantial commitment of time, effort, and money, and there are few shortcuts such as buying into the Japanese production system through mergers and acquisitions, and this is due to the heavy cross ownership of shares among Japanese companies.

Japan's attitude toward production and consumption are a third category of impediments to a more open market. These attitudes underpin both the governmental and private sector barriers. Traditionally, Japanese are taught that Japan is a small poor country with few natural resources. Therefore, Japan has to import raw materials and export manufactured goods in order to survive.

Under this dominant mindset, protection and promotion of manufacturing industries is linked to natural survival. This linkage helps explain Japan's drive for self-sufficiency in manufacturing at home and for a dominant position in key markets abroad. It also helps explain some of the data Robert Lawrence presented on the degree to which Japanese firms control Japanese trade.

At home the drive is manifested by attempts to produce and maintain production in some declining and also in high-technology industries where Japan is not competitive internationally. Abroad the drive is manifested by the longstanding practice of Japanese companies to place top priority on obtaining market share even at the expense of profits.

While these are the barriers, various economic, social, and political forces are pushing Japan in the direction of greater market openness.

Representative HAMILTON. Mr. Ahearn, excuse the interruption. We have a vote pending, and before you begin this next section of your statement, I think we'll take a recess and come back. We will conclude with your statement and then go into questions.

The committee stands in recess.

[A recess was taken for members to vote.]

Representative HAMILTON. The committee will resume its sitting.

Mr. Ahearn, you were in the middle of your statement, and we apologize to you for the interruption, but you may proceed.

Mr. AHEARN. I had just finished describing some of the Japanese barriers and had moved on to the potential for change.

While I've described the barriers, various economic, social, and political forces are pushing Japan in the direction of greater market openness. At the same time, there are forces operating at cross-purposes to the pressure for change.

The primary forces for a more open Japanese market are economic. The dramatic rise in the value of the yen since 1985 has propelled a rising level of imports, particularly of manufactured goods from South Korea, Hong Kong, Singapore, and Taiwan. In 1988, the Japanese imports of manufactured goods were 80 percent above those in 1985 in volume terms, a dramatic change.

The import expansion has been facilitated by the opening of new distribution channels, rising consumer consciousness, and changing consumer tastes. There are also a variety of political and social forces for a more open Japanese market.

The Maekawa Report issued in 1986 is evidence that some members of the ruling elite recognize that it is in Japan's interest to become a major importing country. Some key members of the leadership of the Liberal Democratic Party have begun to play a more important role in shifting Japan's trade policy toward a greater balance between imports and exports. There are also a growing number of individuals in the private sector and in government who are proderegulation and proimport expansion and who are natural allies for foreigners and their efforts to open up the Japanese market.

Support for change within Japan is also bolstered by the global interests and views of Japan's multinationals. The executives of these top companies generally do not want or need bureaucrats regulating their activities and do not want their access to foreign markets threatened by Japan's protection of its home market. The globalization of Japan's corporations may also serve to break down many exclusionary business practices and help transform traditional Japanese attitudes.

On the other hand, Japanese politics in society place significant constraints on rapid change. The fragmented and factional structure of the Liberal Democratic Party has inhibited development of a policy oriented style of leadership that could accelerate the market opening process. Without strong domestic leadership, foreign pressure is likely to continue to be the key force for change.

Powerful vested interests in Japan, farmers, small shopowners, developers, and construction companies, oppose import liberalization. The political power of these vested interests interacts with a growing role for politicians who are overwhelmingly concerned with domestic and not foreign impacts.

The power and control exercised by Japan's ministries over import flows is another continuing problem in opening Japan's markets. In general, the ministries with the narrowest jurisdictions tend to be most opposed to import liberalization. Even ministries, such as the Ministry of International Trade and Industry, that have broad jurisdictions tend to be in favor of open markets only in the areas of jurisdiction of other ministries.

Despite the Maekawa Report, there may not be a growing national consensus or even debate in Japan about the need to open markets at an accelerated pace. Highly publicized calls for the internationalization of Japan by Japanese officials my be quite empty if the majority of Japanese citizens believe that the concept involves understanding other cultures better, but not changing Japanese practices or policies to become more open to the outside world.

In short, it is possible that the reluctance of the Japanese people to support what we in the United States regard as consumer interests, to question the authority of bureaucrats, and to break out of clannish groupings may continue to sustain Japan's protected market and to restrain the pace of market opening reforms.

I conclude with an assessment of the prospects for greater market openness. Currently, the forces for a new Japan intent on becoming more open to the outside world are persistently running up against the historical and inward looking values, practices and institutions of the old Japan.

Under these conditions, the course of Japan's market opening reforms continue to be incremental and uneven, and Japan's market may continue to be perceived as relatively closed by the rest of the world. Progress in opening Japan's market will continue, but the market openings in some areas may be accompanied by market closings in other areas.

It is also possible, however, but much less probable that over the medium and long run either the forces for a new Japan or the forces for an old Japan could come to predominate. The outcome, of course, is very important. A more open market could improve the well-being of specific U.S. companies, it could dilute the competitive advantage Japanese companies derive from high domestic prices and it could eliminate a longstanding conflict between Japan and the rest of the world. Failure to accelerate the opening of Japan's market could lead to a continuation of trade conflict.

Mr. Chairman, that concludes my remarks.

Thank you.

[The prepared statement of Mr. Ahearn follows:]

PREPARED STATEMENT OF RAYMOND J. AHEARN

Mr. Chairman, Members of the Committee, it is with great pleasure that I appear before you today to testify on the Japanese market. My statement assesses three categories of Japanese trade barriers, examines the forces within Japan both for and against change, and evaluates the prospects for a more open market. Under current conditions, my conclusion is that the course of Japan's market opening reforms likely will continue to be incremental and uneven. This view is based substantially on a recent report I wrote on this topic at the request of Senator William V. Roth, Jr.[1] With your permission, I will read a shortened version and submit the full statement for the record.

JAPAN'S TRADE BARRIERS

Japan has made progress over the past decade in removing traditional trade barriers in an effort to open its market to foreign participation. The formidable array of formal trade barriers that Japan employed at the border in the 1950s and 1960s to protect its industrial sector--high tariffs, extensive quotas, and bans on foreign investment--have been mostly dismantled. The changes have been spurred by a combination of foreign pressure and self-interest in reducing the shackles of a heavily regulated economy.

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[1]Japan: Prospects for Greater Market Openness, Congressional Research Service, Report 89-390 F, June 26, 1989, 65 p.

Despite the progress made, numerous other impediments to trade associated either with government regulations and practices, exclusionary business practices, or Japanese attitudes remain. These continuing impediments to trade impose economic costs on U.S. firms, enhance the competitiveness of Japanese competitors, and put stress on the overall U.S.-Japan relationship.

Governmental Trade Barriers and High Domestic Prices

A variety of Japanese governmental regulations and practices constrain imports and contribute to Japan's high domestic prices. According to Japan's Economic Planning Agency, unregulated consumer goods (i.e goods that are not subject to any kind of restrictions in Japan) were 36 percent more expensive in Tokyo than in New York in 1987. Consumer goods that were subject to restrictions in Japan (e.g. food and liquor) were 92 percent more expensive. There has been little change in these ratios in 1988 and 1989.

A great deal of controversy in U.S.- Japan trade relations revolves around Japan's high prices. High domestic prices allow Japanese companies to earn substantial profits that can be used to subsidize both research and development and aggressive export drives abroad. If cheaper imports could freely enter Japan, Japan's high prices would be reduced to world levels and much of the controversy over Japan's "closed market" would terminate.

Agricultural import barriers are one important cause of high food prices. A substantial portion of Japan's agricultural imports are protected by quotas or high tariffs, thereby raising domestic producer prices above world prices. Japanese consumers pay three and four times the world price for many of their food purchases.

High prices in Japan are also related to government restrictions on distribution. The distribution system is dominated by small "mom and pop" shops. Over 1.5 million such shops control 55 percent of Japan's retail sales. While these stores often provide excellent service, they carry small inventories, limited selection and few imports. Unlike large department stores and supermarkets, these small shops tend not to carry imports because they are dependent on Japanese producers for credit and are often obligated to carry only their products.

The dominance of "mom and pop" shops is perpetuated by regulations curtailing the ability of large department stores and supermarkets to establish new stores. Local ordinances, applied by an estimated 60 percent of Japan's towns, require large retailers to get approval from all existing shopkeepers within a third-of-a-mile radius to open new stores. National regulations embodied in the Large Retail Store Act of 1974 decree that no retailer can open a store larger than 5,382 square feet -- an area about one-tenth the size of the smallest K Mart store in the United States -- without permission from both local councils and the Ministry of International Trade and Industry (MITI). Obtaining such approval is difficult and time consuming. Only about three dozen large stores open each year in Japan, usually after five to eight years of negotiations.

Japan's very weak enforcement of antitrust laws also contributes to high prices. Japan's Fair Trade Commission (JFTC) remains primarily concerned about stability in markets and preventing what the Japanese call "competitive chaos." Instead of restricting monopolies and other abuses of market power, the JFTC tends to concentrate on regulating various kinds of sales promotions, such as coupons and service discounts. This orientation of the JFTC makes it difficult for new entrants to introduce their products to Japanese consumers and to reward distributors for promoting their products.

Exclusive practices in distribution and hundreds of legal cartels also tend to drive up prices substantially. Matsushita Electric, the giant electronics firm, relies on a distribution network of 26,000 independently owned small retailers that sell and service only that company's brand of products. In the consumer electronics industry as a whole, around one-half of all sales are handled by retail stores that are controlled by Japanese manufacturers.

Cartels authorized by various statutes and administrative actions are pervasive in Japan. According to the JFTC, in 1988 there were 310 Japanese cartels legally exempt from the antimonopoly law. In addition, Japanese government regulations restricting entry into or exit out of industries and explicit price and output directives also have a price raising effect. The JFTC has estimated that approximately 40 percent of Japan's economy is subject to substantial government regulations, many of which have a price effect. This percentage would be considerably higher if informal measures, such as administrative guidance, were included.

Exclusionary Business Practices

Exclusionary business practices are one of the most important barriers to imports. The problem lies in the organization of Japanese business and the tendency of companies to buy from long-standing Japanese suppliers. Japan's structure of corporate interdependence, subcontracting networks, and reciprocal relationships raise significant barriers to foreign producers trying to break into Japan's market for intermediate-and capital goods. U.S exports of highly competitive machinery, electronic components, telecommunications equipment, and computers are most affected by these barriers.

The most well-known economic groupings, *keiretsu*, consist of six major groups: Mitsui, Sumitomo, Sanwa, Mitsubishi, Fuyo, and Dai Ichi Kangyo. These groups account for an estimated quarter of sales and one-third of capital in Japan's business sector. Each group typically includes a major bank, a trading company, and noncompeting companies in industries such as steel, consumer electronics, and household appliances. Each company in the group owns shares of other companies in the group.

The main purpose of these groups is to serve as a source of stable and preferential trading relationships. Business is fostered to the maximum extent within the "family" and a certain amount of willingness to pay above market prices to help out one's group partner is expected. Intergroup dealings account for an estimated 20-30 percent of total sales for some group members. The nature of this intergroup favoritism has been described as follows:[2]

> "Mitsubishi companies pay their wages through Mitsubishi Bank, rent their head offices from Mitsubishi Real Estate, and their storage space from Mitsubishi Warehouse. By choice they use air-conditioning units made by Mitsubishi Electric, machinery made by Mitsubishi Heavy Industries, trucks made by Mitsubishi Motor, and fuel supplied by Mitsubishi Oil. Their factories are insured by Tokio Marine and Fire, the group insurance company, and the beer for their forget-the-year parties is supplied by Kirin, the group brewer."

Many of the big companies such as Sony, Honda and Matsushita have achieved world class status without affiliating with any group. But they have set up vertically integrated groups of their own. A major car manufacturer, for example, has 156 primary subcontractors, who are ultimately responsible

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[2]Tasker, Peter. The Japanese, E.P. Dutton, New York, 1987. p. 52.

for delivery of parts. Below the primary subcontractors are 3,500 secondary subcontractors, who in turn, contract out to over 10,000 backyard operators.

Instead of being guided primarily by market forces and lower cost alternative supplies, parent companies and their subcontractors work out mutually acceptable arrangements for sharing good times and bad. In lean years, parent companies will reduce bonus payments, limit wage hikes, or lay off part-time workers. Subcontractors, in turn, will cut costs any way possible to supply intermediate goods at the lowest possible price. In good times, the process reverses itself with the parent company rewarding all those who made accommodations to get through the lean period.

This buying within the family orientation covers a wide spectrum of the Japanese manufacturing sector. It provides Japanese industry with a certain "natural immunity" to imports, making official protection unnecessary in industries characterized by a nexus of intercorporate relationships where price is not the most important consideration.

One way to break through this system and to sell in Japan's producer goods markets is to establish a manufacturing facility in Japan. Some U.S. companies that have done this have become part of the Japanese system and have become very profitable. In general, this requires a substantial commitment of time, effort, and money. And there are few short-cuts, such as buying into the Japanese production system through mergers and acquisitions, due to the heavy cross-ownership of shares among Japanese companies.

Attitudinal Barriers

Japan's attitudes towards production and consumption constitute other impediments to a more open market. These attitudes underpin both the governmental and private sector barriers. Traditionally Japanese are taught that "we are a small, poor country with few natural resources. Therefore, we have to import raw materials and export manufactured goods in order to survive." Under this dominant mind-set, protection and promotion of manufacturing industries is linked to national survival.

This linkage helps explain Japan's drive for self-sufficiency in manufacturing at home and for a dominant position in key markets abroad. At home, the drive is manifested by attempts to produce and maintain production in some declining and also in high-technology industries where Japan is not competitive internationally. Abroad, the drive is manifested by the longstanding practice of Japanese companies to place top priority on obtaining market share even at the expense of profits.

The case of supercomputers--where Japan refused to buy a foreign product that it was in the process of developing domestically--illustrates

Japan's drive to promote an infant high-tech industry.[3] The case of soda ash illustrates Japan's reluctance to phase out a declining industry.[4]

The flip-side of Japan's producer bias and the drive for control of production wherever possible are consumer attitudes. Many Japanese, particularly those over thirty-five, believe the success of Japanese companies in world competition simultaneously supports their own-well being and their nation's. High prices and limited selection are generally considered an acceptable price to be paid for supporting the success of Japanese companies in the international trade arena. Moreover, Japanese consumers tend to worry about how import competition could affect their jobs and disrupt the harmonious set of inter-personal relationships associated with the status quo. As a result, "consumer groups" in Japan are more concerned with health hazards of imported goods and preserving stable (domestic) supplies than with increasing consumer sovereignty through greater selection and lower prices.

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[3]A U.S. firm produced the first supercomputer in 1976. Japan did not produce one until 1983. During this seven year period, Japanese-funded public entities refused to buy any supercomputers from the United States while Japanese firms were busy developing their own production capability. Once Japanese firms began producing supercomputers, the refusal to buy from U.S. suppliers eased only slightly. U.S. supercomputers today have 20% - 25% of the Japanese private market versus 75% worldwide and only around 3% of Japan's government funded market.

[4]Japan's Fair Trade Commission found in 1982 that a cartel was illegally restricting imports of soda ash. As a result of the finding, the market share for the much more price competitive U.S. product increased from 3 percent to 15 percent. Despite continuing and significant price advantages, the U.S. market share subsequently has remained stable. This is difficult to explain without assuming that some tacit understanding among customers persists.

POTENTIAL FOR CHANGE

Various economic, social, and political forces are pushing Japan in the direction of greater market openness. At the same time, there are forces operating at cross-purposes to the pressures for change.

Forces For Change Within Japan

The primary forces for a more open Japanese market are economic. The dramatic rise in the value of the yen since 1985 has propelled a rising level of imports, particularly of manufactured goods from Hong Kong, Singapore, South Korea and Taiwan. In 1988, Japanese imports of manufactured goods were 80 percent above those in 1985, in volume terms. The import expansion, which has slowed marginally in 1989 relative to 1988, has been facilitated by the opening of new distribution channels, rising consumer consciousness, and changing consumer tastes.

These changes are driven largely by Japan's huge trade surplus and by popular demands for higher living standards. Assuming the yen remains strong, imports should continue to expand rapidly in the years ahead.[5]

There are also a variety of political and social forces for a more open Japanese market. The Maekawa Report issued in 1986 is evidence that some members of the ruling elite recognize that it is in Japan's interest to become a major importing country. Once consensus is reached, Japanese society does have great capacity for implementing new policy directions. This societal trait

[5]Japan, however, has a long way to go in reducing the value of its $80 billion global trade surplus and in reaching its potential as a major importer of manufactured goods. Japan's imports of manufactured goods as a percentage of apparent consumption are still among the lowest among all industrialized countries.

could be tapped by the Government of Japan to make import expansion a national economic priority, thereby quickening the pace of market opening.

Some key members of the leadership of the Liberal Democratic Party (LDP) have begun to play a more important role in shifting Japan's trade policy toward a greater balance between imports and exports. A growing number of key LDP leaders recognize that it is in Japan's interest to further open its market to the outside world.

Some individuals in the private sector and government, who are pro-reform, pro-deregulation, and pro-import liberalization, are natural allies for foreigners in their efforts to open up the Japanese market. With a growing number of potential Japanese allies, foreign businesses could have greater success in lobbying for reductions in Japanese trade barriers.

Support for change within Japan is also bolstered by the global interests and perspectives of Japan's multinationals. The executives of these top companies generally do not want or need bureaucrats regulating their activities and do not want their access to foreign markets threatened by Japan's protection of its home market. The globalization of Japan's corporations may also serve to break down many exclusionary business practices and help transform traditional Japanese attitudes. Other factors making for a more open and diverse Japan are: the need to hire foreign labor, the entrance of women into the labor force on a more equal basis, shorter work weeks, changing skill requirements in the labor force, and a younger generation that does not totally accept the group-oriented ways of their parents.

<u>Obstacles To A More Open Japanese Market</u>

On the other hand, Japanese politics and society also place significant constraints on rapid change. The fragmented and factional structure of the LDP has inhibited development of an individualized and policy-oriented style of leadership that could accelerate the market opening process. Without strong domestic leadership, foreign pressure is likely to continue to be the key force for change. As a result, nationalist and isolationist groups in Japan that resent foreign pressure and the opening of Japanese society and institutions to outside forces are likely to grow.

Powerful vested interests in Japan--farmers, small shop owners, developers, and construction companies--oppose import liberalization. These interests maintain influence through heavy representation of rural districts in the Diet and are supported by the opposition parties and elements of the LDP. The political clout of vested interests interacts with a growing policy-making role for politicians who are overwhelmingly concerned with domestic, and not foreign, impacts. In addition, growing familial recruitment patterns of Japan's interlocking elites suggest that there are few internal forces influential enough to shake up Japan's political system to the degree necessary to significantly accelerate the pace of market liberalization.

The power and control exercised by Japan's ministries over import flows is another continuing problem in opening Japan's market. In general, the ministries with the narrowest jurisdictions tend to be most opposed to import liberalization. Even ministries such as the Ministry of International Trade and Industry (MITI) that have broad jurisdictions tend be in favor of open markets only in the areas of jurisdiction of <u>other</u> ministries.

Japan's strong bureaucratic tradition is one reason why the passage of laws and streamlining of procedures does not necessarily open up markets, particularly in the area of customs and standards. The fastidious interpretation and implementation of existing regulations pose ongoing problems in getting goods into Japan. Certain weaknesses of Japan's legal system--shortages of lawyers, courts, and judges--make it difficult and time-consuming to challenge the bureaucrats.

The Maekawa Report notwithstanding, there may not be a growing national consensus or even debate in Japan about the need to open markets at an accelerated pace. The highly publicized calls for the "internationalization of Japan" may be empty if the majority of Japanese citizens believe that the concept involves understanding other cultures better, but not changing Japanese practices or policies to become more open to the outside world. In short, it is possible that the reluctance of Japanese people to champion what we in the United States regard as consumer interests, to question the authority of bureaucrats, and to break out of clannish groupings may continue to sustain Japan's protected market and to restrain the pace of market opening reforms.

Prospects for Greater Market Openness

Where is Japan headed? Is Japan opening to the outside world, experimenting with new values, altering its economic structure, and reordering its political system in recognition of its new international interests and stature? Or, is Japan still clinging to the inward-looking and mercantilistic practices that promoted its post-war economic recovery?

Currently, the forces for a "new Japan" intent on becoming more open to the outside world are persistently running up against historical and inward-looking values, practices and institutions of the "old Japan." Under these conditions, the course of Japan's market opening reforms may continue to be incremental and uneven and Japan's market may continue to be perceived as relatively closed by the rest of the world. Progress in opening Japan's market will continue, but market openings in some areas may be accompanied by market closings in other areas.

It is also possible, however, but much less probable, that over the medium and long run either the forces for a "new Japan" or the forces for an "old Japan" could come to predominate. The predominance of the "new Japan" forces could lead to an accelerated pace of reform; the predominance of the "old Japan" traditions and practices to a slowdown in the reform process.

The stakes are formidable. A more open market could improve the well-being of specific foreign companies and workers as well as Japanese consumers, dilute the competitive advantage Japanese companies derive from high domestic prices, and eliminate a long-standing conflict between Japan and the rest of the world. Failure to accelerate the opening of Japan's market could lead to a continuation of trade conflict.

Representative HAMILTON. Thank you very much, gentlemen, for excellent statements.

We will proceed here under a 10-minute rule I presume with questions from members.

Let's begin with the question you concluded with, Mr. Ahearn, and that is does Japan have an open market?

Mr. Prestowitz, you answered that pretty clearly. You said Japan's market is not an open market, and, of course, I remember your comments with regard to a discussion about openness being useless, but I want to kind of get the general drift of it here.

Mr. Lawrence, your view is that there are significant barriers, as I recall, and yet dramatic change is occurring. So your conclusion is what, is it an open market or not?

Mr. LAWRENCE. Well, it's still not open.

Representative HAMILTON. It's not an open market, but getting better.

Mr. LAWRENCE. Getting better.

Representative HAMILTON. And, Mr. Ahearn, your conclusion is what?

Mr. AHEARN. My conclusion is that Japan is opening, is in the process of opening, but is not fully open——

Representative HAMILTON. But is not an open market now, right?

Mr. AHEARN. Right.

Representative HAMILTON. Now let's get in mind the barriers that we have, and you talked about those quite a bit, Mr. Prestowitz. What are the major barriers? Sum that up for me in a sentence or two, and let's go right down the line.

Mr. PRESTOWITZ. Well, the major barrier is a different concept of human organization. Someone asked me here earlier why there is no consumer movement in Japan. The reason there is no consumer movement in Japan is because to have a consumer movement you have to have consumers who think they have individual rights and they want to enforce those rights, and that they are privileged to enforce those rights against their government or against anybody else, and Japan doesn't think in terms of individual rights. It's a hierarchical, group oriented, traditional kind of a society.

So what happens is that out of that grows, for example, keiretsu, the Japanese industrial structure, as Mr. Ahearn pointed out, that includes large cartel elements. Seventy percent of the shares listed on the Tokyo Stock Exchange never change hands. Those very large industrial organizations have great power to control retailers and to control the distribution to the retailers.

Representative HAMILTON. And the traditional things we negotiate about in GATT, for example, just don't reach these at all; is that correct?

Mr. PRESTOWITZ. No. The GATT was constructed by us and by the U.K. in our own image. It was based on the idea that everybody understands what open is and everybody understands what equal rights is and what a free market is.

Representative HAMILTON. What are the barriers, Mr. Lawrence, in your view?

Mr. LAWRENCE. Well, I think they are a combination. I would say that when you come to agriculture, a very key sector, there aren't conceptual problems. There are quotas, there are restrictions and those can be negotiated readily, but they are a critical barrier.

I think, No. 2, there is the fact that it's a society which values long-term relationships, and long-term relationships mean that outsiders have difficulty entering, and I agree with Mr. Prestowitz that these are entry barriers to foreign and domestic new entrants. It's very hard to negotiate with, but there are—well, I guess we're going to get into it later.

Representative HAMILTON. Mr. Ahearn, barriers.

Mr. AHEARN. I would put top priority on government regulations and practices that have the effect of boosting up domestic prices. Second, the buying within the family orientation that affects our exports of intermediate and producer goods. The question of attitudes is third. The attitudinal component underpins both the governmental barriers as well as the private sector corporate barriers.

Representative HAMILTON. The ones you mentioned in your statement.

Mr. PRESTOWITZ. Can I add one comment, Mr. Chairman?

Representative HAMILTON. Yes.

Mr. PRESTOWITZ. There is also another factor, and that is that any country that has an active industrial policy logically has to have barriers. If you establish it as a matter of national priority to be a leader in semiconductors or aircraft or whatever it is, then you will have national policies aimed at achieving that leadership and you will not welcome large influxes of foreign products into those markets.

For example, we have a commitment to being in space. The Russians have cheaper and more reliable launch vehicles than we do, but we are not going to import Russian proton rockets because we have policy objectives, and Japan has those policy objectives pretty much across the board of its industrial sector.

Representative HAMILTON. Do you agree with Mr. Lawrence and Mr. Ahearn that a lot of progress is being made in opening the Japanese market?

Mr. PRESTOWITZ. Well, I think that there have been some changes in Japan. I'm hesitant for two reasons, Mr. Chairman. One is that I have been watching Japan since 1964, and there have been a lot of changes in Japan since 1964. The problem is that whenever we tell ourselves that Japan is changing implicitly, we mean it's becoming like us, but it's possible to change and not become like us.

So I'm hesitant to say that Japan is becoming like a Western, market-oriented society, and I would also say that we've had a halving of the value of the dollar against the yen. In response to that, I agree with Robert Lawrence, there has been some changes in Japan, but the question is in order to get to where you want to go, where we would like to go, how far do you have to go? Are we talking about 50 yen to the dollar or 20 yen to the dollar in order to impose that change?

Representative HAMILTON. You look at the figure Mr. Ahearn cited, that Japanese imports of manufactured goods were 80 percent above 1985, and that's impressive, isn't it?

Mr. PRESTOWITZ. Yes. I mean there is no question.

Representative HAMILTON. Is that largely because of the change in the currency?

Mr. PRESTOWITZ. Yes.

Representative HAMILTON. It's not largely because of opening the market.

Mr. PRESTOWITZ. Well, I think the point that Robert Lawrence made is very important here, or two points. One is it's from a low base. So I mean if you go from a one to a two it's a hundred, but it's still a low base. Second, however, much of that is Japanese industry moving low value-added manufacturing offshore. It's still in Japanese hands, and there is a difference between imports and openness. Openness would imply that anybody could play. They have had a substantial increase in imports, and I think that's a plus. It doesn't mean it's an open market.

Mr. LAWRENCE. I have done some statistical studies which ask the question if you take what you would have expected in terms of the way the Japanese economy normally responded to changes in the price of imports and economic activity, has there been an unusually large increase in their imports of manufactured goods, and I find that there has been.

In other words, when you do the statistical test, you find they are about 10 to 20 percent higher than you would have expected on the basis of that historical relationship. That does suggest something beyond the pure influence of the price, but, as Mr. Prestowitz points out, it's still working off a small base.

I think a second thought is that according to the date I could find, while the imports coming into Japan are being largely conducted by Japanese companies in the way that Mr. Prestowitz indicated, in my testimony I also pointed out the fact that direct sales by U.S. companies bringing in exports from the United States also increased quite considerably.

Representative HAMILTON. How do you feel about the bilateral trade imbalance? Do you think that is going to improve or not with Japan?

Mr. LAWRENCE. Well, my own sense is given what has happened to the currency and given the fact that the dollar has backed up, I would be surprised if we see much improvement.

Representative HAMILTON. In the next year or so. What kind of a timeframe are you talking about?

Mr. LAWRENCE. Well, I would be talking about over the next year or two, and in fact it could well get worse.

Representative HAMILTON. Do you agree with that, Mr. Ahearn?

Mr. AHEARN. Yes, and I would also add that the bilateral trade imbalance really is relatively unaffected by Japan's trade barriers. The bilateral trade imbalance is driven more by macroeconomic factors and not by trade restrictions.

Representative HAMILTON. What is your view on the trade balance?

Mr. PRESTOWITZ. I think the bilateral deficit will tend to get worse over the 5 years.

Mr. LAWRENCE. Just let me add, certainly if we look at it in U.S. dollars. If you look at it in yen it will improve, and that's a critical problem in a sense because we have this bias to think that the way you should measure things in dollars. And it turns out that since

Japanese prices in dollars rise, the price of their products, the last thing to turn around will be that bilateral deficit.

Representative HAMILTON. I want to jump now to this concept of managed trade.

Mr. Prestowitz, you're identified with that phrase. I don't know whether you accept it or not. You can tell us here in a moment. But I must say I have a little trouble understanding what we mean by managed trade and how it differs from what we are now doing. Are you an advocate of managed trade?

Mr. PRESTOWITZ. Well, I'm a pragmatist, Mr. Chairman.

Representative HAMILTON. That sounds like a politician's answer. [Laughter.]

Mr. PRESTOWITZ. My feeling is, and I agree with you, we are managing the trade now. We are managing trade in semiconductors, automobiles, machine tools, steel, textiles, and telecommunications. We're managing trade right now. But not only are we managing trade in those areas where we have agreements that have been criticized as protectionist, but we manage airline trade between here and Japan. We manage fishing trade. The Commerce Department has a fish and chips policy in which we allocate fish in our waters to foreign fishermen, and there are other areas of trade that we manage.

I would even go beyond that and say that in circumstances in which our companies are operating in a market, and even if we, the United States, did not have a policy to manage trade in that area, if another country has an industrial policy in that area, then de facto the trade will be managed, maybe not by us, but then it will become subject to the industrial policy of the country that is pursuing the industrial policy.

Representative HAMILTON. Would you like to see us manage more trade than we do now? Would you like to see us manage trade with Japan and, if you would, what do you mean by managed trade?

Mr. PRESTOWITZ. I would like to see us manage the trade more intelligently than we do, and let me just cite two examples. We are managing autotrade with Japan, and this is probably the most damaging kind of management to the United States. Prices have been raised in the United States and the rents and the profits have been creamed off to the Japanese industry.

The U.S. industry has not been compelled to come up with any plan to improve its competitiveness, and Japan has a bargaining chip in the trade negotiations because the United States is constantly aware that it needs to have these agreements renewed. This is a very poor way to manage trade.

Now, let's look at airlines. In the case of international airlines we don't ask for free trade. We should. We have some of the world's most economical carriers and we don't ask for them. We don't ask for it because we know that to be a real country you have to have an airline, and countries like Switzerland, Sri Lanka, Japan, France, and even we are not going to allow foreigners to buy their airlines or to fly domestic flights.

So recognizing that we are not going to have free trade, rather than insist that the other guys are cheaters or that they are not free traders or their market is not open, we go to them and we say let's cut a deal.

Now, interestingly, we don't negotiate for specific market share, but what we do is we negotiate the parameters of the market. We negotiate frequencies, destinations, landing fees, and so forth. The result is a regime in which there is competition, and the market share fluctuates, but it's not perfectly free competition. We don't know whether U.S. airlines across the Pacific are going to get 50 percent or 45 percent or 65 percent of the traffic, but we do know they are not going to get zero.

What I'm proposing is that let's be honest and recognize that we have, we do and we will enter into managed arrangements because many of the markets in which we operate are not going to be free markets. So let's recognize that and let's identify those markets that are not likely to be free markets and let's negotiate the parameters of those markets such that we maintain a maximum possible level of competition, but we assure that we're not going to be disadvantaged by the inevitable nonmarket nature of the competition.

So I would like to go around and say well, you know, we ship soybeans to Japan. The Japanese don't grow soybeans. That's basically a free market situation, no need to manage it and let's put it in the free market category.

Representative HAMILTON. You don't think of managed trade in the large terms like we're going to make a reduction in bilateral imbalance?

Mr. PRESTOWITZ. Set a target. I don't think that's useful. I mean for one thing if you set a target with Japan—see, I think the composition of trade is very important. I would rather ship supercomputers than logs, and if you set a target, that's where you'll go.

Representative HAMILTON. I want to come back to managed trade in a few minutes. I have taken quite a bit of time, but we'll come back and have you, Mr. Lawrence and Mr. Ahearn comment on that.

Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

I want to just give a footnote to your comment, Mr. Prestowitz, that there is no consumer movement in Japan. I just got back from Japan last night. I was there for an environment conference, a Parliamentary Conference on the Environment on Monday and Tuesday. So I was able to have Tuesday there and get back Tuesday night.

Mr. PRESTOWITZ. You're lucky.

Representative SCHEUER. I think I'm entitled to the door prize for having been the most tired Congressman in the history of our country from flying to Japan for 2 days. [Laughter.]

Representative SOLARZ. I once went to Beijing for dinner. [Laughter.]

Representative SCHEUER. I believe it.

Mr. PRESTOWITZ. Yes, but it was a good dinner. [Laughter.]

Representative SCHEUER. I talked to Takako Doi and I talked to their former Environment Minister, who is now Secretary of the Cabinet, both of them women and both of them emerging as powerful forces in Japan, and they give all the earmarks of talking about stimulating a consumer movement or women's movement on the subject that we were discussing, namely, the environment and pushing Japan to improve its environmental behavior around the world in their forestry practices where they sought to mimic a 14-year-old boy putting a straw into an ice cream soda and it's all gone. They are very much aroused at that, and they give signs that they are going to organize women to change Japanese behavior, both corporate behavior and government behavior on environmental considerations.

If you will remember, one of the reasons that Takako Doi got elected was because there was an organized protest by the farmers on the introduction of more imports of food from the United States, meats, citrus products, and so forth, and the women who objected to 3 percent sales tax.

Women are getting organized, they are understanding that they have political rights and they have access to their government. These two women both have soared to power and prominence through helping to organize that feeling, and I think you may see the emergence of a women's movement that will consider cheaper products and breaking through some of the impediments in their organizational structure for distribution in the near future.

I get from the three of you that there is not a great deal of improvement going on. I guess, Mr. Prestowitz, you summed it up best when you said we don't understand trying hard and they don't understand open.

You as a trade negotiator know how awfully difficult it is to spend years negotiating a particular commodity or a particular manufactured product over 2 or 3 years and then find that over several years after that, although the deal was negotiated, in practice it was far less effective than one had hoped.

I don't know if we have enough trade negotiators to negotiate each manufactured product and each agricultural product for several years, especially considering their ability to spring forth with an almost limitless number of other impediments, legal, organizational, bureaucratic, you name it, they have it.

What would you say to an approach by which we suggest to them, look, you know your own market better than we do. You're quite familiar with all of these formal and informal, legal, and non-legal barriers to access. You know your capacity to increase purchases of American products by Japan as well as opening up your market further to American products.

We now have roughly a $50 billion surplus with you, Japan, and we think that ought to come down, and it can come down through increased imports by Japan of American products. In other words, if you want to take more citrus fruits or meat, fine, or if you want to buy American products, that's fine. Each of those will reduce the trade balance, and we think it ought to come down over a period of 10 years from the $50 billion to either zero or a manageable figure.

You work out the details either by increased purchases by Japan of American products or increased access by American firms to Japan's market, and let them come up with proposals, but say here are the guidelines and here is the ladder by which we want you to help us step down our trade deficit. If we can't do it that way, then we're going to have to look at our totally open access or almost totally open access by Japan manufacturers to our market, and maybe the adjustments will have to come at that end, but we prefer not to do it that way.

I would like to know what you think, and I would like to know what Mr. Lawrence and Mr. Ahearn think to that approach.

Mr. PRESTOWITZ. I don't support that kind of an approach for several reasons.

One is that if you just set that kind of a target without any more elaboration, Japan might actually organize to meet it, but it's likely the way that it would be met would be by importing logs, soybeans, and raw materials, low value-added products. I personally feel that as a nation we ought to be aiming for high value-added manufacturing which justifies high wage levels and high living standards. Composition is important, and if we leave the composition entirely in Japanese hands it will not be to our advantage.

Second, I don't really think frankly that the size of the trade deficit itself is the key issue. In any case, I think that the ability to change the size of the trade deficit through trade negotiations is limited. I don't think it's zero, but I think it's limited because it is also related to our macroeconomic policies, and as long as we have no savings in this country, it's going to be hard to have a trade surplus or even a balance.

But beyond that, even if you could reduce the size of the trade deficit by trade negotiations substantially, I would point out that we have a sizable trade deficit with Canada, and we have had for the past several years a sizable trade deficit with Europe.

Neither of those deficits have stimulated the concern and the problems and the friction of the Japanese deficit, and the reason is because it's not the size of the deficit that causes the problem. It is the feeling of nonreciprocity and a feeling of unfairness that arises because of their definition of open and our definition of open, their idea of try hard and our idea of try hard, and we always get driven back to that.

Implicit in all of our efforts here is an attempt to get open, what we think of as open, and while I may be prepared to accept that Japan is a more open society today than it was 20 years ago, I think you're going to wait a very long time before you get a Japan that's open in the way that Americans would be happy with it.

What bothers me is that we impute goodness to openness, and inevitably when we say what's not open, the conclusion is it's wrong, it's bad, it's unfair, and we want to change that and hit at it. And somehow or other I would like to get us to the point where we could say, gee, it's not open and that's not unfair and that's not bad, but it just means we're going to have to handle it differently than we normally do.

And just as we do with airlines, when we negotiate with Sabena or with Swiss Air, we don't tell them open or we'll clobber you, but we tell them we understand your not going to be open, OK, let's make a deal. I would like to do that with Japan and remove a lot of the poison from the atmosphere.

Representative SCHEUER. Thank you, Mr. Chairman.

Representative HAMILTON. Do you want the others to comment?

Representative SCHEUER. Yes, if they have a comment.

Mr. LAWRENCE. Well, I agree that I think this is a bad idea. I think there is a desire on the part of Americans to somehow find a quick fix to this question, and there are a few simple solutions.

One actually is let's negotiate a free trade area. We don't have to get involved in the details. These lead to a lot of friction. Let's not hassle with that. Let's just agree on some new simple rules, and in fact a free trade area with Japan would remove those barriers at the border, only those barriers at the border and, in my judgment, wouldn't achieve much change in what we're worried about.

A second idea is let's just give them a total and let's give them a target. Indeed, I guess many people have suggested that. My judgment is that that will not change, like Clyde Prestowitz, that won't change the fundamental problems involved in our relationship.

I mean if you start to play in your minds how the Japanese would deal with a target, with an aggregate trade deficit target, well, let's think about this.

First, they have a choice, and it all depends on how you frame this thing. Are they going to reduce their exports to the United States or are they going to increase their imports from the United States. My own judgment is whenever given that choice, the politically simply thing for the Japanese has always been to reduce their exports.

So what we would find is that the Japanese Ministry of International Trade would turn around to Japanese firms who produce what they consider to be less essential products, low-tech products and tell them, you guys, you have to get out of Japan, you have to go and invest in the United States.

We would still find that our high-tech companies continue to be subjected to immense competition from Japanese high-tech companies. MITI would surely say low-tech guys, you go abroad, and high tech, you have the priority access to the U.S. marketplace. Semiconductors, supercomputers, you're the people who can sell in the United States. So that whole technology friction will continue.

On the import side, again, what we would find increasingly are those companies who the Japanese could control would be doing the importing, that is to say Japanese companies. So what you would find is maybe a rise in Japanese imports, but really under the aegis and supervision of MITI.

Our policy of saying to the Japanese you can have discretion over the details essentially drives the Japanese firms or places them under the control of MITI. When we embark on these so-called voluntary restraint arrangements, we are basically granting their Ministry the ability to deny or provide access to the U.S. marketplace to Japanese firms, and that immensely increases the power of their Ministry.

So my judgment is we have to think through what we want and, in my opinion, the kind of structure you will effect by saying you achieve a quantitative target is not a structure which we will like. In my judgment, there is no substitution for getting down and dirty into the details, for going through that painful process of negotiating sector by sector, of asking what are the barriers in great detail and where can we eliminate them.

Representative SCHEUER. In the high value manufacturing sector.

Mr. LAWRENCE. Well, whatever we decide is our priority now. Now I do think we should be guided by some—not that we should set quantitative targets, but we should not be guided by the firms that squeal the loudest. We should sit down and ask where do we really expect that the greatest gains for American exports will come. Those should be the sectors we should choose to prioritize. Then we sit down and we examine in great detail the obstacles in those sectors.

Now, by the way, we did this in the MOSS talks. We had a series of four sectors. Now what is so interesting is if you actually look at the U.S. exports in those sectors, between 1985 and 1987 they increased by 46.5 percent. That compares with a 24-percent increase in our overall exports to Japan.

I wouldn't necessarily look at that and say that failed. Take tobacco, for instance. Sure, painful. I mean negotiations dragged on over many, many years. Today we have 12 percent of the market. So I think there is no substitute for, No. 1, an immense commitment of resources.

We can't send negotiators in who don't have experience and who don't have knowledge and who don't have staff, but I don't see any alternative but to talk about the details of the structure.

Mr. AHEARN. I would just emphasize if your target is the reduction of the trade imbalance, you have to focus on the macroeconomic underpinnings of that imbalance, the savings shortfall of the United States as well as some of the artificial stimulants that Japan provides to savings that bolster its excess savings that, in turn, are channeled to the United States.

Trade negotiations in trying to open Japan's market can affect the composition of trade as well as the level of trade, but they are unlikely to have much of an impact on trade imbalance per se.

I agree with Mr. Lawrence that getting down and working hard on negotiating openings in particular sectors can have an impact. I would also argue that enhancing the power of the Japanese bureaucracies may be a short-term tradeoff that we have to consider in jawboning particular large companies to buy more from foreign sources.

Clearly in the long run we would prefer to see a reduction in the bureaucratic power in Japan, but at least in the short term to deal with corporate trade barriers, it may be very difficult to make any progress without strong bureaucratic guidance.

Representative HAMILTON. Congressman Solarz.

Representative SOLARZ. Thank you very much, Mr. Chairman.

Mr. Prestowitz made what seemed to me to be a very interesting point, that although we have trade imbalances with Canada and the EC, our trade imbalance with Japan seems to generate much greater anxiety, which he attributed largely to the degree to which Canada and the EC had more open markets than Japan did, and this in turn generated resentments over here that we weren't playing from a level playing field.

Perhaps, but I can't help but take note of the fact that although the British and the Dutch have substantially greater investment in the United States than Japan, most of the anxieties about foreign investment in our country tend to be focused on the Japanese, which suggests to me there may be another explanation for this phenomena and that may have to with race. I'm not necessarily convinced that that is the fact, but there is a very deep suspicion on my part that that does in fact have a lot to do with it.

I would like to be the devil's advocate and challenge it seems to me some of the assumptions flying around here.

If you look at our trade deficit with Japan in 1988 compared to what it was in 1980, in 1980 it was $12 billion and in 1988 it was $52 billion. Yet, during most of the 1980's as a result of a whole series of trade negotiations we in fact managed to get Japan to remove many of the obstacles which were identified at the beginning of the decade as significant obstacles to American exports to Japan. Tariffs were greatly reduced, many of the quotas were eliminated, some of the regulations were changed and we were given input into the drawing up of standards and the like.

And, indeed, over the course of the 1980's the level of American exports in Japan went up substantially, from $20 billion in 1980 to $37 billion in 1988. That's more than a 50-percent increase. Yet, at the same time that our exports went up, our imports went up even more.

So let me begin by putting to you the proposition and ask for your response, that the single most significant factor in explaining the existing imbalance in trade has to do with our budget deficit which resulted in a very substantial increase in demand here in the United States.

If we could get back to a $12 billion trade deficit with Japan, it might not meet my good friend, Congressman Scheuer's idea of zero, but I suspect he and many others would consider this to be a great achievement. Well, at the beginning of the decade when the Japanese market was substantially more closed than it is today that was the trade deficit.

Therefore, I ask you is it not true, in your judgment, that the main explanation for this increase in the trade deficit has much more to do with our own budget deficit than with obstacles to American exports to Japan in Japan itself?

Mr. PRESTOWITZ. Well, I think there is no question that the way the United States has been running its own economy in the last 10 years has not been calculated to reduce our trade deficit, and certainly the lack of savings in the United States and the overvalued dollar have had a very substantial impact on the size of the U.S. trade deficit with Japan.

But I would hestitate a little bit and throw out a couple of caveats. One is that the Europeans do not have these horrible budget deficits and lack of savings that we have, and they haven't suffered from overvalued currencies. But they have big and increasing trade deficits with Japan, and they engaged in the same kind of corrosive and friction ridden negotiations that we have with Japan.

The Koreans have the highest rate of savings in the world, budget surpluses, and nobody would accuse the Koreans of trying hard and not being good exporters. They have a deficit with Japan, and they engage in the same kind of corrosive negotiations with Japan that we do.

The same is true of the Taiwanese. In fact, the Taiwanese at one point simply raised tariffs on a thousand Japanese items a couple of years ago.

So, sure, our macroeconomic policies have been bad and have had a very deleterious impact on our trade deficit with Japan, but again I think Bob is right. We are always looking for the silver bullet. That's part of it, but that's not the silver bullet.

Again I would say yes, we have removed apparent barriers, tariffs and quotas and the like. But anybody who understands the Japanese game of go understands the whole point is that you have multiple defenses. The things that make it difficult to operate in the Japanese market, which I mentioned earlier in my statement—even for Japanese, and let's forget about Americans—newcomers in Japan have a hard time penetrating their own market, and these things haven't gone away.

Mr. LAWRENCE. I think you're right when it comes to the deficit. I think if you ask why do we have this large trade deficit, it really does reflect our own savings and investment behavior.

Indeed, I did a study where we simply took American exports and imports in 1981, and then we said proportionalize the changes across our trading partners, and what we found was we could track by 1987 almost exactly what our imports and exports were with each trading partner.

That suggests the whole development was a pervasive one, and that points to the fact it wasn't just our exports with country *a* or country *b* or our imports from those countries. Since it was proportional, it suggests pervasive, and you don't have to look further than the U.S. dollar for the major driving force, and behind that dollar, in turn, you see our own macroeconomic policies.

So I do think that the aggregate deficit issue is our problem in a sense, and the real issue here is that we may well take a lot of actions that change the Japanese marketplace and open and not affect the trade deficit one wit, and if we focus our attention on that, we could have continued friction, as indeed we are likely to see, even if the Japanese are undertaking structural changes.

If we don't see a change in macro behavior, more imports into Japan will result in more exports from Japan and the overall deficit won't change. Indeed, a policy which says we are not going to change our own spending patterns, but we want the Japanese to import more in an economy that is virtually fully employed will result in more exports.

Representative SOLARZ. Mr. Ahearn, did you want to comment?

Mr. AHEARN. I certainly agree with you that the budget deficit is the driving force behind the large bilateral trade imbalance as well as the aggregate trade imbalance. The question perhaps should be, and I think you were suggesting this, that if we had a trade imbalance with Japan of $12 billion would we be here today? Well, I'm not sure. My view is that the problems we have in selling to Japan still would be of a kind that would lead the United States to pressure Japan to continually open its market.

Representative SOLARZ. I have time for one other question, and I would ask each of you to comment on the extent to which the remaining barriers, things like the distribution system, and one, by the way, that you could conceivably add to that is language. I mean very few Americans speak Japanese. We don't, of course, take the trouble to learn it, but they take the trouble to learn English.

I suspect we have very few American businessmen in Japan selling American products who speak Japanese. They probably have thousands and thousands of Japanese who speak English hawking their merchandise over here, and one could theoretically argue that the language over there was a barrier to American trade.

To what extent are the main remaining obstacles to American exports to Japan, things like the distribution system, consciously designed to keep foreign exports out of Japan, and to what extent are they a reflection of indigenous considerations reflecting Japanese culture and social values that may have the incidental effect of reducing foreign exports, but are not designed to keep foreign exports out?

And if they are designed to keep foreign exports out, but simply have that effect, then how do we really go about saying to another country even though you're not trying to keep our exports out, we can't point to some conspiracy here which we object to. How do we go about saying to them that because your culture works to the disadvantage of our exporters we want you to change your culture? I mean that strikes me as the height of hubris.

Would anybody dream of saying to them we insist that English should be the language of instruction in the schools so that American exporters will have an easier time selling their products in Japan? I mean that suggestion would be laughed out of court. I'm not at all sure that asking them to change the distribution system if we don't believe it's consciously designed to keep out American products is any different. I mean if they attach a certain loyalty and a certain value to continuing to do business with people with whom you have always done business in the past, that may make it harder for us to break in and it makes it harder for their people to break in. But how do we come off telling them that's no good?

I mean I have a pollster, and I have known the man for 20 years, and he is one of my very good friends. When I have a campaign I don't go around soliciting bids from every other pollster in the country to see if I could get my polls done for 5 or 10 percent less because I have a relationship with this fellow and I value that and I want to maintain it, and I'm not sure it's any different in Japan.

I wonder if you could comment on that, those reflections.

Mr. PRESTOWITZ. I essentially agree with you. I think in a sense it's all of the above. I wouldn't emphasize culture so much because, for example, the keiretsu structure of Japanese industry is a conscious government choice. They could decide to enforce their antitrust laws in a different way if they wanted to, but they don't want to. But, nevertheless, it's a choice that they made, and whether it's a policy choice or a cultural choice in a sense I think is not important.

I don't know how you would come up with a percentage and say so much of it is conscious barriers, some of them are, and so much of it is policies that the Japanese have pursued. I mean part of the policy behind the kieretsu back in the 1950's was to make it difficult for foreigners to buy in. So in the 1950's it was a conscious policy to prevent penetration.

Today it's a legacy of a policy of 30 or 40 years ago, and to some extent the emphasis on personal relationships in Japan is part of Japanese culture. I don't know how you tear all that apart. But my bottom line is, I think, the same as yours. I think it's kind of useless to try.

As you know, I have had a lot of experience in trying to open this market as a U.S. trade negotiator, and I have just come to the point of saying this is a silly exercise. We should go to them and tell them to change their distribution system. We shouldn't go to them and tell them that they shouldn't have long-term relations. We would look silly doing it, and we would look unfair to them. In their eyes we look like crybabies and we're unfair and making unreasonable demands.

What we should rather do is to say to ourselves, well, they have the situation and we probably can't change it, and even if we try we will engender terrific resentment and we might even make a few changes.

Bob Lawrence talked about the MOSS talks. We made some progress in the MOSS talks, but I want to tell you there was a price to be paid for that. I personally paid a price for that, and other U.S. trade negotiators have done the same thing, and we pay a price as a nation in negotiating capital and relationships, and I'm not sure it's worth that price.

So what I would rather say is look, we can't change these people, and we don't even know if we should. If we have a problem with this, and if we don't like the fact that we can't sell supercomputers there and they can here, then let's deal with that on a pragmatic basis and just go to them and say, hey, we don't like this and let's figure out a deal, and they would do that.

The problem is that they're pragmatic enough to cut a deal, and we're the ideologues. We want to insist on making them into our image. You can't do it.

Mr. LAWRENCE. Well, I think there are areas in Japan and practices which are not necessarily endorsed by everyone in Japan. I think clearly what we have to do is to find issues and areas where there is a coincidence between what we would like to see and areas where there exists political support in Japan.

I mean I get the sense that there is a growing sense among Japanese that there is something wrong with the fact that goods are so expensive in the country. I mean as more of them travel, they discover those 47th Street photo phenomenon, that you can buy Japanese products more cheaply in New York than you can in Tokyo.

I think that this is an area where in some sense we should be putting a lot of attention, and this is one area where I agree, we don't have to get into the details.

We need to continuously point out on a sustained basis, and in fact I would recommend that every time any American official went to Japan he went on a shopping spree, a publicized one. It would have to be financed by government funds since it would cost him so much, but he should find products. He should be sent by the Embassy to go on a spree ideally with a number of TV cameras trailing him, and he should simply say, look, I bought this pen in New York for five bucks, and look what it costs here, 25 bucks. He should be doing this on a continuing basis to raise consciousness of the fact that prices are so different.

I think in the food area, I mean it is clear to anyone who looks at the basic structural problem of the Japanese economy is they are doing the wrong thing with their land. They ought to be living on it, playing on it, and building houses on it and not growing food, and that is clear to everybody. There is an immense political problem that has to be dealt with, and frequently Japanese have used outside pressure and have found it helpful in trying to induce changes in that regard.

So I don't give up on all kinds of structural changes. It does mean we have to pick our battle. We have to get a sense of where it is fruitful. Indeed, Clyde Prestowitz in his book describes very vividly the way in which he tried to play certain Japanese Ministries off against one another in a way that any decent negotiator would do since there are frequently domestic interests who would like to see what you would like to see achieved, but it requires a detailed knowledge and understanding of the society and a finger on the pulse of the political changes that are taking place.

So I don't give up on the negotiations simply because in some sense they are different. Some of the things that are different I think you may well have to live with and others you could well change.

Mr. AHEARN. I agree with you, Congressman Solarz, that culture is a very slippery concept, but I would like to emphasize the way in which the Japanese have used it to their own advantage in the past. They have told us that they could not import foreign skis because their snow was different; that they could not import more beef because their intestines were too small; and that they could not hire American or foreign construction firms because their soil was different. Even yesterday in the Style section of the Washington Post we learn that Japan cannot open up their movie houses at 9 o'clock in the evening because the Japanese people have to get home and to bed early.

We hear time and again how Japan is unique and how Japan is different. Clyde Prestowitz and others have argued that if Japan is unique, then we have to treat them differently. This line of reasoning poses a fundamental threat to Japan and should temper their reliance on the "uniqueness" argument to impede imports.

Representative SOLARZ. Thank you, Mr. Chairman.

Representative HAMILTON. Congressman Wylie.

Representative WYLIE. Thank you, Mr. Chairman.

I apologize for being late. This is an important hearing, and I commend Chairman Hamilton for having it. I wanted to be here on time, but I was called to a meeting with the Secretary of the Treasury—which seemed to be rather preemptive this morning—I have read your prepared statements.

According to the London Economist, there has been a turnaround in the Japanese society so that consumption is now in vogue and savings is less important, and during Secretary Mosbacher's recent trip to Asia he stressed the theme of allying our trade interests with those of the Japanese consumer.

Are U.S. retailers doing all they can to benefit from this development, if you think that is a valid assessment? Are our big retailers closed out of the Japanese retailing market? Are there consumer groups in Japan which might push for positive change?

Mr. Prestowitz, would you like to start off?

Mr. PRESTOWITZ. Consumer groups in Japan are very weak. In fact, I have a vivid memory of being picketed at the U.S. Embassy by the Federation of Japanese Housewives for objecting to the import of inexpensive American agricultural products.

As far as big retailers are concerned, and put aside American retailers, a large Japanese retailer may not open a store without getting the consent of all of the smaller mom and pop shops in the vicinity in which he wants to open his large store. This entails getting a license from MITI, it entails having hearings in the local area, and it has tended to be a very long, drawn-out process, and Japanese retailers have been really constrained from taking advantage, if you will, of this so-called boom in Japanese consumption.

I think again the issue is not so much Americans or Americans trying hard enough. I think it's again a case where we just see a different definition of what open means and a different approach to organizing economic activity.

Representative WYLIE. Then you say consumer groups in Japan aren't strong enough to push for what might be regarded as favorable change in this area. Do I read you correctly?

Mr. PRESTOWITZ. Yes, that's right.

Representative WYLIE. Mr. Lawrence.

Mr. LAWRENCE. Well, it is noteworthy in the food area that the consumer groups in Japan have basically expressed this tremendous concern about security of food, and since they are heavily financed and influenced by the farm interests, they define their interest in terms of ensuring secure supplies. So you have there a clear case where they may well have a voice, but they are not saying what we think they ought to be saying. So I think it's a process that has to be nurtured, but it's not an easy one.

Let me also say that simply getting American retailers into Japan but retaining a lot of the barriers that still may exist for imports, they may not behave very differently from the retailers who are already there.

I find it very striking, or I mean interesting that last week Apple Computer and Canon have been reprimanded, and I guess they may well be tried by the Japanese Fair Trade Commission for practices which allegedly keep Apple Computers much more expensive in Japan and much more than they are in the United States.

So you see when an American firm gets into Japan perhaps, and I don't know the facts of this case, but it's quite plausible that given the particular structure that they find in place, they would behave exactly like Japanese firms. So we shouldn't confuse entry for our firms with opening of the marketplace.

Representative WYLIE. Do you agree with that assessment, Mr. Prestowitz?

Mr. PRESTOWITZ. Let me just add something. On the question of consumer items and their availability in Japan, in 1988, we exported about 37 billion dollars' worth of goods to Japan, and only 10 percent were consumer durables, and it's in that area that we face great competition from the Europeans as well as the other countries in Asia. So I think we sometimes put undue emphasis on availability of consumer items in terms of our trade negotiating priorities because it's not an area in which we are necessarily that competitive.

In terms of consumer groups, I did an economic seminar in the city of Nagoya several weeks ago, and I was struck by the statement of one banker who argued that Japanese consumers were getting fed up with the high prices, that they wanted more availability, greater selection and lower prices, and he said that they are going to rise up and do something about this.

Then after he had made his statement, I spoke to several other people that were attending this seminar, and they all told me that this man was just engaging in what they called wishful thinking. The point is that there are no real consumer movements as we know them in Japan today.

Representative WYLIE. We do a good job of producing agricultural products, and none of you mentioned those. Should we use agriculture as a top priority in our trade talks?

Mr. AHEARN. Well, we have. We have put a good deal of emphasis on agriculture, and, in fact, agriculture is the area where I think we've had perhaps more success in removing barriers than in some other areas. Japan is our largest market for agricultural exports.

My own feeling is that because Japan is not an efficient agricultural producer, that it's appropriate for us to continue to ask for a removal of residual tariffs and quotas, but here you get into the rice question. Should Japan open its market for rice, and this is something that lies close to the heart of many Japanese.

Mr. PRESTOWITZ. I'm not sure that we should press them to open their market for rice. In the name of free trade we could well wind up engendering very deep resentment toward the United States. So I'm not sure that that's the route we should go.

Again, I come back to saying I would like to throw away ideology. I would like to stop worrying about whether they are open or closed and whether they are free marketers or not free marketers. I would like to just figure out what kind of relationship we want with these people and then sit down and negotiate it with them.

Representative WYLIE. There has been some testimony here that has led support to the belief that raising the value of the yen relative to the dollar has greatly helped our bilateral trade balance with Japan.

Is there anything that we can do or should be doing to get the value of the yen even higher, say from 145 yen to the dollar even to 100 yen to the dollar over the next 2 or 3 years?

Mr. Lawrence, would you like to take a crack at that?

Mr. LAWRENCE. Well, I think yes. Again, it comes back to our macroeconomic policy. I think actually without a program to withdraw purchasing power from our economy ideally through the budget deficit, to have the currency fall could well be too inflationary for our economy.

So one part of a package to see a weaker dollar, in my judgment, has to be a budget deficit solution. I think just simply trying to drive the exchange rate down, indeed trying to lower the trade deficit without having something on the other side to withdraw buying power from our economy is likely to be inflationary. So it is part of a broader package.

I think intervention by itself, indeed as the episode with the Group of Seven has proven over the last couple of weeks so far at any rate, isn't very effective when there are fundamental factors in monetary policy, in particular, in the United States which are tending to support the currency. So the currency is definitely one part of the picture. I think there is very clear evidence that the Japanese market does respond to relative price changes.

Representative WYLIE. Mr. Ahearn, I saw a nod from you. Do you want to comment?

Mr. AHEARN. I have nothing to add to Mr. Lawrence's statement.

Representative WYLIE. All right. Thank you very much, gentlemen.

Thank you, Mr. Chairman.

Representative HAMILTON. Congressman Obey.

Representative OBEY. Thank you, Mr. Chairman. I'm sorry I was not here on time.

Mr. Prestowitz, I would like to come at this question from the opposite side of the coin that Congressman Solarz came at it from, and that is the question of the budget deficit. I will readily grant that our macroeconomic policy has not been designed either to strengthen our trade posture or for that matter our manufacturing base in this country, to say the least, and I would readily grant that it would be wonderful if we could deal with our macroeconomic idiocy tomorrow.

I would like to try to put in some perspective what that remainder would look like even after we had waved that magic wand and had done that, and I guess what I would ask you or Mr. Lawrence or Mr. Ahearn, any of you, I would ask you these questions.

First of all, let us say that by 1993 we did in fact through some magic conversion of will reach zero deficit, at least as we now measure it. What I would ask you is what do you think our trade picture would look like with Japan if we did that, and what would be the nature of and shape of and the size of the remaining problem?

Mr. Lawrence indicated that we needed to have priorities. What would your priorities be for action by private corporations or action by the Government in terms of changing policy, and how might the corporate world and the Government world work together to try to buttress each other as we select those priorities, whether they be sectoral or otherwise?

I wonder if all three of you could respond to that.

Mr. PRESTOWITZ. Well, I think that if we did everything right on a macroeconomic basis, I'm not sure that our bilateral deficit with Japan would change all that much.

Let's not forget that we had a bilateral deficit with Japan in the early 1970's, which President Nixon said was intolerable and we then severed the dollar from gold, and at that point it was $2 billion.

Then in 1978 and 1979 it was about $12 billion. I mean I came to Washington in 1981, and Secretary Baldrige told me that my job was to reduce the trade deficit with Japan. When I left 6 years later, I owed them $5 billion.

The British do not have our big budget deficit, but they have a large and growing trade deficit with Japan. The Germans have a surplus of capital, but they have a substantial and growing trade deficit with Japan. Our trade deficit with Japan is now structural.

For example, there is a study being done by the University of Michigan which projects that our trade deficit in automobiles will be doubled by 1995 despite a production in the United States of something close to 2 million Japanese cars because all those plants are going to pool in Japan for parts and for capital equipment. As the population of Japanese cars in the United States grows, the service parts and so on will come from Japan increasingly.

So we have a big structural deficit here, and I don't know that just changing the macroeconomic policy is going to touch it. Overall if we had a substantial budget surplus in the United States we would probably have a lower overall trade deficit, but that doesn't necessarily mean with Japan.

Now with regard to priority, I couldn't agree more with Bob Lawrence that we need to sit down and think about priorities. If you think about what we do at the moment, we send Carla Hills to Japan and we tell her to tell them to open their markets.

Essentially, and this is a little bit simplified, but this is essentially what happens. Carla or Lynn Williams, the Deputy U.S. Trade Representative go to Japan and they say please open your market. The Japanese say, well, OK, which ones do you want us to open, and we respond and say well all of them of course.

And then the Japanese say, OK, we know you Americans are idealists, but which ones do you want opened first, what are your priorities? And then we are absolutely lost. We don't know. And the way we select our priorities is who comes in the door first, who has the best Washington machine or just that some official in the U.S. Government takes an interest in a particular product.

I mean I was instrumental in getting supercomputers on the negotiating list just because I happened to be interested in supercomputers at the time. Nobody thinks about this stuff in the U.S. Government. Now how should we do that?

Well, you get driven back to the question of what do you want your domestic economy to look like. How can you know what you want to negotiate with Japan unless you know what you want the structure of your domestic economy to look like?

It seems to me that this is something we have not engaged in very much, but there are some precedents. I was yesterday in Langley, Virginia, at the NASA Research Labs. They were founded in 1917 at the time when we set up the NACA, the predecessor to NASA. It's interesting. We made a decision in 1917 that the U.S. Government wanted the United States to have an aircraft sector in its economy. That was a decision that we made domestically which then leads to a trade negotiating posture in which we as trade negotiators try to create a positive environment for the U.S. aircraft industry.

We haven't engaged in this kind of thinking in the United States for a long time. We did it in 1917, but we don't do it now because we shy away from the dreaded words "industrial policy."

But the fact is that there are criteria out there, and for a lack of better ones why not look at the Japanese. The Japanese have said they want their economy to be founded on industries that are characterized by a high elasticity of demand, high knowledge content, long-term falling cost curves and multiple impacts on other industries.

If you have become the low-cost producer in steel, you've taken a big step toward being the low-cost producer in everything that steel goes into, and these are the criteria that the Japanese apply. I don't think they are such bad criteria, and I think it would be very worthwhile for our government to sit down with industry across the board and to look at those criteria, think about them, study them, develop other criteria, and come up with some priorities so that our trade negotiator is not naked when he or she sits down to talk with people who do have priorities.

Mr. LAWRENCE. Well, I think that a significant deficit would remain simply from the fact that what hasn't come up today, but I think is critically important, is that one major determinant of the structure of Japanese trade is the fact that the country is poor in natural resources.

Now I don't happen to believe it accounts for all of the reasons why they have a low share of manufactured goods trade, but it is significant. That means they are going to run deficits with OPEC, and if they run deficits with OPEC and they are saving a lot so they are going to run a surplus everywhere else, they are going to have to run surpluses with the other countries of the world by definition, and I think that's a driving parameter of the structure of the Japanese economy.

I think it's important not to place too much attention on this question of the bilateral trade deficit. There are other issues involved. The fact is that we should, and indeed the title of this hearing is the question of whether the Japanese market is open or not, and we should be negotiating to open that market actually because it's in our interest regardless of what the overall deficit level is. Anything that is going to raise the demand for American exporters is going to improve our terms of trade.

If it should happen that the United States is going to run a very large trade deficit, we are still better off being able to have access to that marketplace. If we are going to try to close the deficit, we would be better off if we can get more exports through a removal of barriers than to having our currency declined.

So for these reasons I think we should keep our eye on the ball, which is not the trade deficit, bilateral or aggregate, although for some purposes that may be important, but in this case the question of is that Japanese market as open as it could be and can we negotiate to remove those barriers.

Then I think having determined that, we ought to sit down. Now I personally am not enamored with the idea of deciding our ultimate industrial structure. In many cases, you see, the tough choice is often not do you want an *x* industry, whatever that is, but how big should it be. Should it be bigger than it is today or smaller than it is today, and those are choices that I think the Government is very hard pressed to make. It's hard to decide that, and I think the market is better suited to decide that.

But, nonetheless, given the fact that the market has determined that we have competitive capacity in a variety of industries, I do think that we should systematically decide where do we have the greatest potential for sales in the Japanese marketplace, and this can be done on a statistical basis. I think there are a variety of economic methodologies that could be used to say what should we expect.

I mean one simple negotiating ploy that we use is to argue, look, if we have 50 percent of the world's semiconductor market in every market, and if we are doing well in Third Country competition, we should expect to get more in the Japanese marketplace. That tells you something about our competitiveness. So it's that kind of study that I think we should use in order to determine where we have the most potential.

Then we look on the other side and see what are the barriers to those particular products and again where is the greatest potential. That's the way I think we have to work.

I think it has to involve the cooperation, obviously, of U.S. companies and firms and people who know Japan, but I think it also has to have this analytical content that I think is lacking from our current strategic approaches.

Mr. AHEARN. Congressman Obey, I think there are two concerns that might arise under your 1993 scenario.

First, U.S. exports certainly would be increasing to Japan, but there would be concern about the degree to which Japanese affiliates are accounting for this increase in U.S. exports, such as TV sets, microwave ovens, and cars. I think if there is a large reduction in the U.S. trade deficit with Japan, much of that will come through exports of Hondas and equivalent products.

The other concern I think that we will still have in 1993 relates to U.S. direct investment in Japan. I think clearly unless more U.S. corporations are directly involved in producing capital and intermediate goods in Japan, they are not going to be able to develop the kinds of long-term relationships which are critical to expansion of U.S. sales and profits.

Representative OBEY. Thank you, Mr. Chairman.

Representative HAMILTON. Do you have further questions, Congressman Obey?

Representative OBEY. No, sir.

Representative HAMILTON. One of the impressions I have from listening to you this morning is that the Japanese consumer is really stomped on.

Mr. PRESTOWITZ. Yes and no, Mr. Chairman.

Representative HAMILTON. I mean there doesn't seem to be any real competition in the Japanese economy. These prices that you mentioned are just extraordinary and the poor little Japanese consumer can't do anything about it. Is that right?

Mr. PRESTOWITZ. Well, Japanese consumers are not treated like American consumers. I think it's important to keep things in perspective. The Japanese consumer's point of reference is not the price in Tokyo and the price in New York. The Japanese consumer's reference is what did I buy 5 years ago and what did I have 10 years ago. Now I went to Japan for the first time in 1964 when it was a poor country, and today it's a rich country.

Representative HAMILTON. Yes, but look they have Japanese traveling all over the world today.

Mr. PRESTOWITZ. A few. I mean there are 120 million Japanese.

Representative HAMILTON. You can't go into any major city today without seeing Japanese. We have them in southern Indiana touring. Now surely some of those people must go back to Japan and say, my gosh, I'm paying $25 for this pen in Japan and it's selling for $5 in Indiana.

Mr. PRESTOWITZ. Keep in mind, Mr. Chairman, that many of those Japanese who are in Indiana or wherever they are working for Japanese corporations, and it has been the policy of the Japanese corporations to do precisely that.

Representative HAMILTON. So they are interested in keeping the prices high. That's an interesting phenomenon about the Japanese.

Listening to your response to Congressman Obey's question, I got the clear impression that you're talking about picking winners, and you want the U.S. Government to identify the particular industries that we ought to help.

Mr. PRESTOWITZ. No, I would say it the other way around. Is there any question in your mind or in the minds of anyone on the panel that for the next 20 years the semiconductor industry, the optical fiber industry, the supercomputer industry, the biotechnology industry, and the telecommunications industry are going to be growing important industries? Is there any question about that? I don't think so.

Representative HAMILTON. But the question is how much subsidy does the U.S. Government give to those industries or, if not a subsidy, then other breaks and other advantages? That's the question, and who decides it?

Mr. PRESTOWITZ. Let's just think about how we do these things now. We broke up AT&T. The breakup of AT&T resulted in an automatic $3 billion trade deficit in telecommunications equipment. That breakup was never reviewed by the Commerce Department, the U.S. Trade Representative, or the Office of the President's Science Adviser. It was done entirely without reference.

Representative HAMILTON. I understand, Mr. Prestowitz, that we do now pick winners from time to time. We have subsidies to high-density television business, for example.

Mr. PRESTOWITZ. Well, not yet.

Representative HAMILTON. Well, we certainly have them. We have the Defense Department. The Defense Department has identified high-density television as a special industry, and they are putting money into that industry. Now that's picking that winner. We do it through a Defense Department agency.

You seem to be suggesting that that's OK and that we do more of that sort of thing and we do it in a more rational and intelligent way. I don't know whether this is good or bad, frankly, to pick winners, but maybe we have to do it.

Mr. PRESTOWITZ. I'm saying, No. 1, we do it, and we do it kind of irrationally ad hoc. No. 2, I'm saying that other people do it, and that we will be forced to respond to their policies.

Representative HAMILTON. You think we're going to have to do more and more of it in order to be competitive.

Mr. PRESTOWITZ. Yes.

Representative HAMILTON. Mr. Lawrence.

Mr. LAWRENCE. Well, I think the key question is how you do it in the sense of——

Representative HAMILTON. But you don't back away from the idea of doing it?

Mr. LAWRENCE. I don't like the idea of selecting industries. I don't think actually industries are very useful analytic devices or policy devices. There are parts of that semiconductor industry that aren't so critical that are like commodities and there are other parts that are very sophisticated.

I think we should have a policy, which we are leaning toward, of providing support primarily for companies and groups of companies who would like to do what you could consider to be precompetitive kinds of research. I think that this is something that the market doesn't do very well. There are generic problems that have to be solved for certain industries. I think that's an area where we could engage not necessarily in selecting specific industries, but perhaps in helping firms who select certain technologies to develop where these are generic in nature.

Representative HAMILTON. And who makes that decision?

Mr. LAWRENCE. I think the firms themselves. I think one mechanism we have is the——

Representative HAMILTON. No, no, who makes the decision in the Government that you're going to provide certain kinds of assistance to industries and, as you put it, at a precompetitive stage?

Mr. LAWRENCE. Well, I think we have a budget and through our tax system we are doing it now, and there is a proposal to improve our research and development tax credit. That's an example.

Representative HAMILTON. But who makes it, who makes the decision, the U.S. Government, and who in the U.S. Government makes the decision?

Mr. LAWRENCE. Well, let me be specific. The decision to allocate funds is made by the Congress and the President who determine the budget. The specific distribution of those funds can be made, and I would favor trying to supplement what the market is deciding. I don't like the idea of the Government picking the winners.

Now let me illustrate what I'm talking about through the research and development tax credit. Here we say that firms who raise their research and development by a certain percentage will get a tax break so that the dollars are primarily coming from the private sector, but the Government is supplementing it.

Representative HAMILTON. Well, the tax break is as much of a subsidy as a direct grant.

Mr. LAWRENCE. Except that who decides who gets it is very different. In the case of the research and development tax credit, individual firms, those closest to the marketplace decide where the prospects lie. They say they want to put their money there and the Government supplements it. So that's the kind of mechanism that I think we could use.

Representative HAMILTON. And you wouldn't go beyond that. In other words, you would conduct your industrial policy through tax breaks basically?

Mr. LAWRENCE. Yes.

Representative HAMILTON. You would give a tax credit for research and development?

Mr. LAWRENCE. Well, I think there may be also a role for bodies like the National Science Foundation and so on.

Representative HAMILTON. Of course, the problem with the tax credit is that you give a 10-percent or a 15-percent tax credit, and we have to draft the language in rather broad language, and it may be the gambling casino over here that takes advantage of it as well as the semiconductor industry. It's a very imprecise kind of a tool, in other words.

Mr. LAWRENCE. But actually over 80 percent it turns out of the money going for the research and development tax credit is audited by the IRS. If you look back, there is a study by the GOA that indicates——

Representative HAMILTON. What does that say to us?

Mr. LAWRENCE. I'm sorry.

Representative HAMILTON. What does that say to us?

Mr. LAWRENCE. That tells us that if you're a large company who realizes you have a very high probability of being audited, you're going to tend to stick to what is laid out in that——

Representative HAMILTON. Well, in any event, you wouldn't have the Government making direct grants to a particular industry in order for that industry to become more competitive, right? You would do it through a tax device probably; is that right?

Mr. LAWRENCE. That's right.

Representative HAMILTON. Now how does that differ from you, Mr. Prestowitz?

Mr. PRESTOWITZ. Well, I'm not sure it does. You see, I think that much more powerful than tax credits and subsidies are all the thousands of administrative decisions and regulations that are made every day.

You know, we set standards for emissions control. The Defense Department has procurement procedures. The Energy Department spends billions of dollars every year in Los Alamos, Sandia, and Livermore.

Craig Fields over at DARPA is deciding every day how to allocate DARPA money, whether it goes to networks or supercomputers or wherever it goes, and at the moment we have no criteria for that. At the moment those decisions are made ad hoc by hundreds of different people based to a large extent on their own interests and views.

Representative HAMILTON. Do you want the U.S. Government then to draw up some rules and principles for deciding which industries are important to the United States?

Mr. PRESTOWITZ. Well, I would like to have some overall criteria to guide the people when they make these decisions.

Representative HAMILTON. What kind of criteria are you talking about?

Mr. PRESTOWITZ. Well, the ones I laid out. No. 1, that we want to be a leader in industry and technology, that we want to be a leader in high-value-added industry and technology, that industries that have falling cost curves, elasticity of demand and high knowledge content are more long-term beneficial to our economy than industries that are slow growing——

Representative HAMILTON. OK, let's say you do that and you make those determinations, and then what are you going to do, are you going to subsidize them?

Mr. PRESTOWITZ. As I said, you know, I would forget about the subsidy for the moment.

Representative HAMILTON. Well, how would you help them?

Mr. PRESTOWITZ. And I would say, OK, we have decided that we would like to go in this direction, and therefore, DARPA, your money should be allocated toward those industries. You have this money already.

Representative HAMILTON. OK, isn't that a subsidy?

Mr. PRESTOWITZ. In a sense it is. I would say to the FCC, when you make your decisions about allocating licenses, they should be made based against those criteria.

Representative HAMILTON. Now that goes quite strongly against your grain, right Mr. Lawrence?

Mr. LAWRENCE. Yes, that's right. First, you know, some of these concepts sound good, and high value added is one. There are many things which have high value added, but don't necessarily meet other criteria. I think it is very difficult to lay out the sound criteria that Mr. Prestowitz has put forward, and I don't see why it's necessarily true that the next dollar we spend is better spent in say developing supercomputers than in trying to improve the efficiency of technology and something more basic like say a steel industry.

I think also, by the way, I favor telling the Defense Department here is your budget, this is how much money we as a society have chosen to allocate for the purpose of national defense and let them decide the best way to spend it.

If those defense experts think that the national defense purpose is better suited by spending their money on developing technologies in general rather than on developing new weapon systems, that's fine, but I think it is very dangerous to start to confuse a defense objective with a commercial objective.

When you look at the French experience, you see that anything you do can always be justified in the name of national prestige or national defense, and I think what has actually been one of the geniuses of the Japanese approach is that it's commercial, which is their ultimate objective.

Representative HAMILTON. Well, that raises a lot of questions about the defense budget, but I don't think I'll try to get into those.

Let me just ask this question, and then we'll go to Congressman Scheuer. We have this structural impediments initiative going on with Japan. We have invoked 301 with regard to three items, and Japan says they are not going to have anything to do with any 301 discussions, and finally we sit down and talk together under the rubric of structural impediments initiative.

How do you all react to that? How is it going? Is this the way we ought to be dealing with our problems with Japan or are we spinning our wheels here or what?

Mr. PRESTOWITZ. We're spinning our wheels.

Representative HAMILTON. Are we spinning our wheels?

Mr. PRESTOWITZ. Just let me remind you that the current structural impediment initiative has received a lot of attention, but it's not anything new. In 1983–84, we had an industrial policy dialogue, and in 1986–87, we had a structural dialogue. The briefing papers were the same, the people were virtually the same and the discussion was the same.

Representative HAMILTON. So in a sense section 301 here has been kind of subsumed in these discussions that have been going on for quite a while.

Mr. PRESTOWITZ. Well, in addition to the discussion, there, of course, are three specific areas that we are——

Representative HAMILTON. Are they taking place in the same forum?

Mr. PRESTOWITZ. No. Those are different meetings, the same people, but different meetings. I can predict what will happen. We are going to come up in the spring and there will be reports in the press of tough negotiations. There won't be much concrete to be shown. The U.S. negotiators will talk about the Congress. They will say, by golly, if you Japanese don't give us something that we can show to the Congress, the Congress will zap you, that mad-dog Congress, and the administration may even come to the Congress and ask you in Congress to make tough noises to help them in their negotiating position.

But then ultimately you get down to the end of the deadline and there will be negotiations until 3 or 4 o'clock in the morning, and then an announcement will be made, a press conference will be held and victory will be declared.

The U.S. trade officials will come up here to the Hill and tell you that the Japanese market is now open, just as open as the American market and that we've had a great success. Then in 6 months there will be another round of complaints and you'll be back in some other kind of structural dialogue discussion and there will be more threats from the Congress and the administration will be warning the Japanese one more time that if they don't give us something concrete the mad-dog Congress will get them.

Representative HAMILTON. Do you see it that way, Mr. Lawrence?

Mr. LAWRENCE. Well, I hope he's wrong. By the way, look at the alternative. Let's take that semiconductor agreement, you know, where in a sense we tried something else. We tried results, right? We thought we had an agreement that the Japanese were going to increase their purchase of these foreign owned semiconductors to 20 percent of the market. If you look at a line of the foreign share in the Japanese marketplace, it has hovered around 10 percent since we concluded that agreement.

It isn't clear to me therefore that the alternative that has been suggested, which is to negotiate about the results has proved to be much effective either.

So I hope he's wrong, and I would hope that we can choose some sectors and achieve some gains, but I'm not under the illusion that we'll change this whole thing over night.

Representative HAMILTON. You're comfortable with the structural impediment initiative, are you? You think that's the way policy ought to be conducted at the present time?

Mr. LAWRENCE. Well, I'm not sure that the resources that should be devoted to it are appropriate. I don't know about the specific strategies that are involved. I see no alternative but to that type of initiative, but I wouldn't want to endorse the specifics.

Mr. AHEARN. At the current time I think the structural impediments initiative is really a superintellectual initiative. I talked to some people in the executive branch and there is still a lot of homework to do. They really haven't even decided which barriers should have top priority in terms of the greatest of potential impact on U.S. exports. You have also three different agencies trying to lead our discussions and a lack of coordination is likely.

So I think I would have to be pessimistic, as Clyde Prestowitz is, about the potential outcome. However, the negotiations are focused on many of the important issues that we have to deal with Japan, such as the antitrust enforcement and government regulations that affect distribution.

Representative HAMILTON. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

One of the big problems that we face in competing with Japan and having access to the Japanese markets is the fact that our products can't really compete with them either in design, quality, or being on the cutting edge of high technology. We have difficulty competing with them.

One reason that we have difficulty competing with them is that we spend less in R&D, in new plant and equipment and in research and development than they do even though they are half our size and it has been discussed. We have a savings rate of about 5½ percent per capita GNP and they have a savings rate of 18 or 19 percent, and that has gone on for a long time.

Should one of the approaches that we should take to improving our access to the Japanese market for new high-tech products at the cutting edge, the kind of things that you mentioned, Mr. Prestowitz, the smart computers, the chips, should we have special treatment either in funding industry research of some kind of joint government-private sector research into a few specified areas in which we have the basic capacity to compete, and should that be a way that we can focus on an achievement that would improve the American high-tech industrial base research and development?

Mr. PRESTOWITZ. There are two pieces to your question. I personally feel that we are lagging in competitiveness and that there are a number of policies that we need to pursue to improve our competitiveness, and I do favor some of the programs that you mentioned.

However, let me say that the problem specifically with regard to Japan is precisely that we do have products that are competitive that we have a hard time selling. We are the leader in fiber optics, we are the leader in supercomputers, we are the leader in networks, nobody questions our quality in those areas, and we still have difficulties. I think that is at the crux of the United States-Japan issue.

Now the other issue is a very important one, and there are both macro and micro economic policies that I think we ought to be pursuing to improve our competitive position.

Representative SCHEUER. Thank you, Mr. Chairman.

Representative HAMILTON. Congressman Wylie.

Representative WYLIE. I just have one more question, and I want to follow up with Mr. Ahearn. I was taken by your statement that we ought to be investing more in plant and equipment in Japan, and I just wonder what you feel the prospects are for American companies being able to do that?

Mr. AHEARN. Well, one of the real constraints now in terms of investing is the incredible price of land in Japan. If you're interested in setting up your own distributor network in Japan, the differences in the cost of a comparable piece of real estate say in the Washington area versus the Tokyo area are just astronomical. The per square foot cost in Japan is in the magnitude of around $4,000 in Japan versus $6 a square foot in the United States. I don't have the precise figures, but——

Representative SCHEUER. Will the witness yield?

Mr. AHEARN. Sure.

Representative SCHEUER. To put it another way, in the United States the land under an office building is generally 20, 25, or 30 percent of the development costs of the building. In Japan the land is frequently more than the total development costs of the building. It's always 80 to 90 percent, and it's frequently 125 percent, and I'm talking about a building that is maybe a couple of hundred million dollars. The Dai Ichi Kangyo Bank Building, the land is worth more than that building, and it's a $300 million bank building.

Mr. AHEARN. You're point is extremely well taken. So American companies have to have an extremely long time horizon if they expect to invest in Japan today and break even over a relatively short timeframe.

Representative WYLIE. Well, then what you're saying isn't really realistic, if I may follow up on it. That restriction may be too difficult to overcome, but the complaints I get are that rules and regulations and administrative detail and so forth are so cumbersome that's it hard for Americans to invest in Japan.

Mr. AHEARN. I'm not an expert on that area, but my impression is that their foreign investment law is not any more restrictive than the laws we have that guide foreign investment.

Representative WYLIE. Thank you very much, Mr. Chairman.

Representative HAMILTON. Gentlemen, the bells have rung again and I think all of us are committed now. We are beyond the noon hour.

We want to thank you for a very, very good hearing this morning, your statements as well as your responses.

The committee stands adjourned.

[Whereupon, at 12:07 p.m., the committee adjourned, subject to the call of the Chair.]

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