

# U.S.-JAPAN ECONOMIC RELATIONS

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Remarks of

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*Recent Japanese moves to reduce import barriers and U.S. actions to defend the dollar are proof that both countries are committed to a stable, free international economic order, according to Mr. Balles. Yet more remains to be done to stabilize the dollar (and other currencies) and to reduce barriers to international trade and finance. The U.S., for its part, must continue efforts to reduce its inflation rate and to restrain oil imports, in order to prevent further turmoil in the exchange markets. Japan, meanwhile, in order to restrain yen appreciation, should do more to raise its growth rate and to move further along the road of reducing import barriers and promoting capital exports.*

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The views expressed in this speech represent only those of the management of the Federal Reserve Bank of San Francisco.

I appreciate the opportunity to comment on Japanese-American economic relations, a subject which is immensely important to all of us on both sides of the Pacific. There has been so much discussion of the differences between the Japan and the U.S. on this topic, that the much larger areas of agreement and harmony have sometimes been forgotten. So it would be useful for us today to review the progress that has been made, as well as the steps that remain to be taken.

Let's consider the three major areas of concern. One is trade, particularly the rapid growth of Japanese exports to the U.S. in the face of the much slower growth in U.S exports to Japan. A second is international banking and finance, with Japanese banks enjoying greater freedom in the U.S market than U.S. banks have had in Japan. The third area concerns the sharp decline of the dollar and the rapid appreciation of the yen over the last year and a half. The point I wish to emphasize is that these areas are inter-related, and of concern to the world community as a whole. In particular, improvement in Japanese-American trade relations may help ease pressure on the yen.

### **Trade Relations**

No issue has been a greater source of irritation and disagreement between the U.S. and Japan than the trade issue. Why is that? Largely because of the rapid growth of Japan's trade surplus with the U.S., which has focused public attention here on the barriers U.S. industries have sometimes faced in selling to Japan. This helps explain why the U.S. government has exerted such efforts to get Japan to raise its growth rate and to open up its markets to imports.

The way in which Japan's trade surplus has developed has raised as much concern as the surplus itself. Specifically, Japanese exports have grown dramatically relative to her imports over the last three years—and this includes exports to Europe and the developing nations as well as to the U.S. For example, the dollar value of Japanese exports reached nearly \$96 billion in 1978. This was 76 percent higher than the 1975 figure, and 21 percent higher than in 1977. Imports in dollars, on the other hand, rose about 39 percent between 1975 and 1978, and about 11 percent between 1977 and 1978.

However, it is important not to exaggerate the Japanese trade performance. The rapid rise in the dollar value of Japanese exports reflects the appreciation of the yen, which has substantially raised the dollar prices of those exports over the last two years. As a result, the volume of Japanese exports has risen much less rapidly than their dollar value. For example, between 1975 and 1978, export volume rose 28 percent while import volume rose 17 percent. More significantly, the volume of Japanese exports in 1978 actually fell about 3 percent below 1977, while the volume of imports increased nearly 6 percent over that same period. From recent indications, Japan's trade surplus—both on a value and volume basis—will probably fall substantially over the next year, as exports continue to weaken.

We must also remember that Japan's trade surplus is only one cause of the U.S. trade deficit. The U.S. deficit also reflects our continued high oil imports, as well as U.S. growth and inflation rates that remain high relative to those

recorded among our major trading partners. Reduction of our deficit will depend upon our success in conserving energy and reducing inflation, along with an improvement in our export trade produced by higher growth rates abroad.

Indeed, we should remember that the U.S. deficit reflects foreign as well as domestic developments—specifically, the fact that foreign growth rates and capacity utilization generally remain low by historical standards. For example, Japan's real GNP grew by 10.3 percent annually from 1960 to 1974, easily the highest growth recorded by any major industrial country. Since then, however, real growth has averaged only about 4.5 percent annually. An increase in growth rates abroad will go a long way toward reducing the U.S. trade deficit. Indeed, attainment of full-employment abroad—a goal already achieved by the U.S.—could lead to an eventual reduction in the U.S. trade deficit ranging between \$10 billion and \$20 billion.

Because of the concern about our trade deficit, U.S. officials have continually urged Japan and other industrial countries to take steps to stimulate their economies. But Japanese officials are also interested in raising Japan's growth rate, as recent Japanese government actions plainly show. Over the last two years, Japan has attempted to stimulate its economy by substantially increasing public works and other government expenditures (in both real and nominal terms). Largely as a result, Japan's budget deficit relative to GNP is now well above the average of the 1960's and early 1970's—as well as above the present deficit-GNP ratio for the U.S. and other major industrial countries.

Rapid Japanese-export growth has also focused attention on the difficulties faced by American and other foreign exporters in penetrating the Japanese market. Japanese barriers encompass both formal and administrative devices. Consider, for example, the following:

- Residual import quotas in 27 (mostly agricultural) product categories;
- Tariffs on manufactures that average several percentage points higher than those applied by other industrial nations;
- Approval and product testing for manufactured imports that can extend as long as 18 months;
- Very high protective tariffs in sectors where the U.S. has a substantial comparative advantage, such as computer equipment, film, and some semiconductors;
- Restrictions upon purchases of imported goods by Japanese public corporations.

Barriers to imports remain particularly severe in labor-intensive and regionally-concentrated industries. Especially frustrating from the American point of view are the restrictions on imports of meat, fruit, and other agricultural products in which the U.S. has a strong comparative advantage.

Fortunately, at least some of these barriers are now coming down. According to a recent U.S. Treasury study, Japanese barriers to imports of both industrial materials and manufactured goods have been lowered substan-

tially over the last ten years. We all welcome the recent Japanese agreement to increase beef and citrus-fruit imports, and to lower tariffs on plywood—but we recognize that some very high barriers on agricultural goods still remain. However, we're all encouraged by the reports that the U.S. and Japan have agreed at the Multilateral Trade negotiations on substantial cuts in tariffs on primary materials and industrial commodities.

Furthermore, we shouldn't blame the sluggish growth of U.S. exports to Japan entirely on Japanese barriers. The U.S. share of total Japanese imports fell from 20.4 percent in 1974 to 17.5 percent in 1977. Indeed, the Treasury study found that the U.S. share of the Japanese market has been falling relative to that of foreign competitors in virtually all major categories. For example, ten years ago the U.S. supplied 58 percent of Japan's coal imports, but the U.S. share has since dropped to 32 percent. To some extent this pattern reflects increased exports to Japan by developing Asian nations, an inevitable and welcome product of their rapid growth. However, American businessmen have sometimes been overly intimidated by the image of "Japan Incorporated," and have not always been imaginative or aggressive in penetrating Japanese markets. In this respect, they have much to learn from Japanese exporters, who have shown great skill in tailoring their products to the American market.

On balance, substantial progress has been made in Japanese-U.S. trade relations. Japanese export growth has slowed considerably in recent months, and some categories have actually registered declines. In 1979, the Japanese trade surplus should decline substantially while the U.S. deficit should improve. Of course,

more progress needs to be made in reducing barriers to trade, not only in Japan but in all the industrial and developing nations of the world. In this respect, recent Japanese-U.S. accords have set a useful example for the rest of the world.

### **International Banking and Finance**

Now let's turn to the area of international banking and finance. Normally, finance raises far less interest than trade in discussions of Japanese-U.S. economic relations. However, maintenance of a sound, free international financial network is crucial to world trade and to the efficient allocation of world investment funds.

Consider the banking sector. Traditionally the U.S. has had a very open policy towards entry by foreign banks. Until recently, foreign-bank entry was controlled not by federal legislation but by state laws, which in the major financial centers were very permissive in allowing foreign banks to branch and to acquire local banks. Until last year, foreign banks also had the privilege of operating full-fledged banking facilities in more than one state, a power denied to domestic U.S. banks. The International Banking Act of 1978 ended that practice, with respect to new multi-state operations. But at the same time, that legislation permanently exempted all existing multi-state facilities of foreign banks from its restrictions upon branching, and it also allowed foreign banks to establish additional non-deposit agencies and branches in any state permitting them.

In response to this liberal treatment, Japanese banks have undertaken a wide variety of wholesale- and retail-banking activities in this country. Currently, 23 Japanese banks

operate 62 banking facilities in the U.S., and their assets (excluding inter-company accounts and clearing balances) more than tripled between late 1972 and late 1978, from \$9 billion to almost \$30 billion. Incidentally, nine of the Japanese banks now operate facilities in three or more states.

Unfortunately, Japanese policy has been less liberal towards entry by American and other foreign banks. Except for a few post-war legacies, U.S. and other foreign banks are able to open only one office per bank, and they cannot establish or acquire local Japanese institutions. Moreover, once established, branches of foreign banks face severe restraints on their ability to compete for deposits or to acquire other sources of local funding, and consequently they must rely heavily on advances from their head offices in financing local lending activities. Additionally, foreign banks in Japan face various limitations on their lending activities.

This disparity in treatment of foreign banks clearly should concern policy-makers in both countries. In view of its large trade surplus, Japan needs to encourage the export of capital, especially if it wishes to avoid further appreciation of the yen. Given better access to local funds, foreign banks can assist Japan in its role as a major capital exporter. Thus, in my view, a badly-needed reform is liberalized Japanese treatment of U.S. and other foreign banks, with greater access provided to more stable and reliable sources of yen funding. In this respect, we should welcome the recent recommendation, by an advisory committee to the Ministry of Finance, to permit both domestic and foreign banks to issue yen-denominated certificates of deposit. Much more remains to be done, however, in the foreign-banking field.

## **The Dollar and the Yen**

Now, while U.S. attention has been focused primarily on trade, Japan's attention has been focused on the foreign-exchange markets. The average trade-weighted value of the dollar is now 8 percent below its September 1977 value, despite the dollar's substantial improvement since last November. However, the dollar has fallen by 30 percent against the yen over the past year and a half—an amount which far exceeds the difference between U.S. and Japanese inflation rates. As a result, Japan's exporters have been faced with the choice of squeezing their profit margins, or of raising their dollar prices and risking erosion of their markets. Compounding the problem has been the unsteady nature of the dollar's decline and the yen's appreciation, which has raised uncertainties about what is in store in the future.

As you well know, the U.S. had been accused of following a policy of "benign neglect" toward the dollar, primarily because it did not intervene in the foreign-exchange markets as heavily or as steadily as foreign central banks did during the past several years. This criticism overlooks two facts. First, the U.S. has intervened forcefully over the last year, and especially since last November, to counter disorderly conditions in the foreign-exchange markets. For example, the Federal Reserve has begun intervening in yen in the New York market to support the dollar, an operation made feasible by the rapid growth in yen transactions there over the last several years. Second, trends in the dollar normally reflect fundamental economic conditions, such as inflation and trade balances, that cannot be resisted by exchange-market intervention alone. The solution to the dollar's problems lies in the correction of these fundamental ills; intervention is only a temporary stop-gap mea-

sure to maintain orderly trading conditions. Those who wish to judge the U.S. government's concern about the dollar should examine its recent policies to reduce inflation and the trade deficit. Our actions in these areas refute any charges of complacency about the dollar's instability.

The dollar's net decline over the last eighteen months reflects two major factors. First of all, inflation has worsened in this country, relative to the inflation pace of some of our major trading partners. Because exchange markets are by their very nature forward looking, they are very sensitive to expected future trends as well as current inflation trends. Thus, the acceleration of price increases here in early 1978 aggravated fears that an already serious situation was about to worsen. Fears about U.S. inflation also made dollar-denominated assets less attractive to foreign holders, leading them to diversify into apparently stronger currencies such as the yen, the German mark, and the Swiss franc. Given these developments, it is not hard to understand why the dollar fell so sharply prior to last November. Nor is it hard to understand why it has been so much stronger since November: Federal Reserve actions to raise interest rates, slow monetary growth, and increase exchange-market intervention apparently finally convinced the market that the U.S. was serious about reducing inflation.

But there is a second factor undermining the dollar and favoring the yen—that is, international-trade developments. As I said earlier, the large U.S. deficit may be due primarily to the relatively faster growth of the U.S. economy. This situation is likely to change substantially over the next year, as foreign growth rates accelerate and the U.S. growth rate decelerates. However, in view of continued high

U.S. oil imports and the erosion of the U.S. position in certain markets, some analysts believe that the U.S. competitive position has weakened over the last several years. Fears of this sort apparently have created some of the continued pressure on the dollar.

Japan presents almost a mirror image of this situation. Its massive trade surplus reflects the unusually sluggish economic-growth trend of the last several years. As this situation changes, Japanese imports will accelerate and the trade surplus will decline. Also, some analysts argue that Japan, as a mature economy, cannot be as export-oriented in the future as in the past, and specifically that it must devote a larger part of its enormous domestic savings to internal requirements—and to foreign direct investment. If Japan fails to make the necessary policy shifts and continues to restrict imports, the exchange markets are likely to force reductions in its current-account balance through yen appreciation.

Again it's important not to dwell too much on past difficulties. The prospects for both the dollar and the yen are for substantially greater stability in 1979 than we saw in 1978. U.S. money growth has slowed significantly in recent months, and this should help to moderate inflation. Substantial improvement in both the U.S. and Japanese trade positions is likely in 1979 as well. As long as these trends continue, there is apt to be much less turmoil in the foreign-exchange markets.

### **Concluding Remarks**

We have witnessed some impressive progress in Japanese-American economic relations over the last several years. Recent Japanese moves to reduce import barriers and U.S. actions to defend the dollar are proof that both countries are committed to a stable, free

international economic order. And the two countries substantially agree on the need to confront the basic problems currently hampering international economic relations, although they may disagree on the specific solutions to some of these problems.

At the same time, more remains to be done to stabilize the dollar (and other currencies) and to reduce barriers to international trade and finance. The U.S., for its part, must continue efforts to reduce its inflation rate and to restrain oil imports, in order to prevent further turmoil in the exchange markets. Japan, meanwhile, in order to restrain yen appreciation, should do more to raise its growth rate and to move further along the road of reducing import barriers and promoting capital exports.

Finally, I want to emphasize that I have focused on Japan-U.S. economic relations because that is the topic of this session. But my remarks should indicate that the problems of dollar stability and international trade are not the responsibility of the U.S. and Japan alone. Other nations maintain barriers to trade—and are working to reduce them at the Geneva negotiations. And other nations will have to join the U.S. and Japan in reducing the U.S. trade deficit. Attaining a harmonious international economic order thus depends on the actions of *all* participants in the world marketplace.



