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Introduction

Paul Krugman

To someone who looked only at the aggregate numbers, it would be hard to explain the U.S. preoccupation with Japan. Only about one-fifth of U.S. imports come from Japan, and little more than one-tenth of our exports are sent there; Japanese firms account for only about 20 percent of the stock of foreign direct investment in the United States, and still employ only a relative handful of U.S. workers. Japan is an important trade and investment partner, but European trade and investment are more important to the United States by any measure and by most measures even Canada bulks larger. Yet for most Americans—not just the general public, but policymakers and academics as well—Japanese trade and investment are *the* central international economic issue.

No doubt much of the focus on Japan represents a mixture of fascination and envy. Fascination, because of Japan's remarkable rise from relative backwardness and crushing military defeat to an extraordinary position of financial and increasingly technological leadership. Envy, because this rise stands in sharp contrast to the gradual decline of U.S. preeminence, which has been accompanied by stagnation or even decline in the living standards of large numbers of American residents. To an important extent Japan stands out because it is a symbol of America's shortcomings, of the disappointing failure of our economy to deliver what we hoped it would.

But there is more to the "Japan issue" than American sourness over a second-place showing. There is also a widespread sense that as Japan has moved from the periphery to the center of the world economy, it has continued to play the game by somewhat different rules than other advanced nations. Rightly or wrongly, more and more opinion leaders in the United States have come to the view that Japan's economy simply functions differently from

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those of other industrial countries—and that as a result the traditional tools and stance of U.S. international economic policy, which worked well enough in a world in which Japan was a minor player, are now no longer good enough. Only some of those who emphasize the Japanese challenge are "bashers," urging the United States to get tough; others are simply admirers, who want the United States to emulate what they perceive to be the Japanese system.

The problem is that, while the debate over U.S.-Japanese trade and investment relations has generated a remarkable amount of heat, facts and serious analysis are still in short supply. Preoccupied with the latest wave of Japanese exports or investments, the debate has done little to resolve the basic questions: In what way does the Japanese economic system differ from those of other industrial countries? What are the effects of these differences? Do they pose problems for amicable economic relations? What can be done to resolve the tensions?

In the fall of 1989 a group of Japanese and U.S. participants held a conference at the National Bureau of Economic Research in Cambridge, Massachusetts, to discuss a number of the key issues in the economic relationship between the United States and Japan. This volume is the result. In introducing the volume, I want to begin with some background to the debate, then review the main issues that arose in the conference.

Defining the Japan Issue

To Japanese government officials and to a considerable number of economists and other observers, the U.S. preoccupation with Japanese differences seems unwarranted. In terms of the conventional measures of international economic policy, Japan is not too exceptional. Agriculture is highly protected, by most measures more so than in any other industrial country; but because Japan remains an agricultural importer, its food protectionism creates less strain on the trading system than the massive export subsidies of Europe's Common Agricultural Policy. Meanwhile, Japan's tariff rates on manufactured goods, like those of other advanced countries, are quite low. And Japan has hardly any of the voluntary export restraint agreements that limit shipment of many manufactured goods into both the United States and Europe. Looking only at the de jure structure of trade policy, one would not be surprised to find Japanese officials claiming, as they often do, that Japan has freer trade than the United States.

Few people in the U.S. policy community, however, accept this benign interpretation. A few still hold to the view of a monolithic "Japan, Inc." More common, however, is a conventional wisdom that runs something like this: despite its relative absence of legal barriers to trade, the Japanese market is de facto protected because it is not competitive in the same way as those of other countries. Collusive behavior involving both firms and a highly cartelized distribution sector effectively shut out many foreign products, even when the imports would be cheaper and/or of higher quality than the Japanese version. Foreign direct investment is similarly choked off by an inability to get local business cooperation, and the inability to establish local subsidiaries inhibits exports to Japan. And this more or less conspiratorial system tends particularly to close ranks when a key new technology is at stake, assuring Japanese firms of a chance to capture new markets even when foreign firms have an initial lead.

What is the basis for this conventional wisdom about Japan? Much of the public case rests on anecdotal evidence—on the stories of businessmen who claim that they could not sell demonstrably superior goods in Japan. Influential commentators on Japanese society, like Karel van Wolferen, have reinforced the anecdotes by offering a portrait of a society very much unlike the freewheeling individualism of the United States or even Western Europe. To economists, however, this is not enough. Anecdotes are useful, but not conclusive—especially when the tellers of the anecdotes are by no means disinterested. Sociology is important, but economists tend to be skeptical of suggestions that social factors lead to a systematic disregard for profit opportunities. In other words, to be persuaded by the conventional wisdom economists would need to be convinced, first, that the anecdotes are borne out by harder, preferably quantitative, evidence and, second, that the supposed preference of Japanese buyers for more expensive domestic products makes some kind of economic sense.

For much of the 1980s, economic controversy over Japanese performance concentrated on a rather crude question: Does Japan import abnormally few manufactures? In terms of raw numbers, Japan looks clearly different from other advanced countries, with 1988 imports of manufactures of only about 2 percent of GNP, versus 7 percent for the United States and 14 percent for the average European Community (EC) nation. On the face of it this comparison seems to confirm the anecdotal evidence of a closed domestic market. But as many economists—perhaps most notably Bergsten and Cline—have pointed out, this raw comparison is unfair.[1] The United States is a resource-rich nation, able to pay for its oil imports by exporting agricultural products; Japan must pay for its raw materials by running a trade surplus in manufactures, presumably in part by importing less. European countries do more than half their manufactures trade with each other; Japan has no neighboring advanced nations.

A number of economists have tried to ask whether, taking these factors into account, Japan still looks like an outlier. The models used to answer this question are themselves the subject of dispute; Srinivasan and Hamada have argued that the whole process of testing for abnormalities in trade is flawed.[2]

1. C. F. Bergsten and W. Cline, *The United States-Japan Economic Problem* (Washington, D.C.: Institute for International Economics, 1987).

2. T. Srinivasan and K. Hamada, "The U.S.-Japan Trade Problem" (Yale University, 1990, mimeographed).

Nonetheless, it seems fair to argue that, in the general debate, the view that Japan does import less than one might have expected wins on points. Particularly influential was a paper by Lawrence that suggested that, after taking resources and location into account, Japan still imports only a little more than half as much manufactures as one would otherwise expect.[3]

Another piece of loose supportive evidence for the conventional view of Japan as a closed economy comes from looking at foreign direct investment. In the United States, foreign-owned firms now produce about 4 percent of GNP and more than 10 percent of manufacturing value added; in European nations the percentages are substantially higher, while in Japan the role of foreign production is negligible.

On the whole, then, the conventional wisdom survives crude empirical testing more or less intact. But this only raises further questions. *Why* does an economy that is de jure open appear to remain relatively closed? Is there an economic rationale for Japanese behavior? Or, alternatively, will Japan in future begin to look more like other industrial nations?

Japanese Trade Patterns

Three of the papers presented at the conference and included in this volume represent, in effect, a continuation of the debate over the openness of the Japanese economy.

Robert Z. Lawrence offers some new kinds of evidence on the ways in which Japan's economy interacts with the rest of the world. Instead of fiddling further with data on the volume of imports, he brings several other kinds of data to bear. One is price data: he shows that prices of many manufactured goods within the Japanese market are much higher than they are abroad, seemingly confirming the supposition that the Japanese market is de facto protected in spite of the absence of conventional barriers. A second piece of evidence is the role of intrafirm trade. Lawrence points out that if the mechanism that blocks imports relies essentially on collusion among firms, then products of Japanese subsidiaries abroad should find it easier to enter the Japanese market—and he finds that indeed Japanese imports are marked by an unusually high volume of intrafirm trade.

Lawrence also draws attention to a new development: the surge of manufactures imports into Japan since the rise of the yen in 1985–87. That surge, starting from such a low base, still leaves import penetration in Japan well below U.S. or European levels. But it shows that access to the Japanese market is not completely insensitive to incentives—that the implicit barriers to imports are more like tariffs than quotas.

Peter A. Petri focuses more specifically on the developments in Japanese

3. R. Lawrence, "Imports in Japan: Closed Markets or Minds?" *Brookings Papers on Economic Activity*, no. 2 (1987).

trade since the onset of the strong yen. He finds that import growth in manufactures has proceeded more rapidly than estimates from the pre-1985 period would have predicted. To some extent the unexpected surge in imports has been concentrated in imports from East Asian NICs, but Petri finds that this trend is too modest to justify talk of an emerging yen bloc.

Petri follows a different approach from Lawrence in trying to understand the sources of traditional low imports into Japan; that is, he asks whether cross-sectional variation in import penetration corresponds to industrial organization in the way that the conventional wisdom predicts. Broadly speaking, he finds that it does. While the principal determinant of Japanese trade patterns in manufactured goods seems to be technology intensity, imports do tend to be lower when collusive insider relationships are most plausible, that is, when the government is the customer, when goods are sold to other businesses, or when high distribution margins suggest a noncompetitive distribution sector.

Yung Chul Park and Won-Am Park pursue further the recent increase in Japanese imports of manufactured goods from East Asian nations. Like Petri, they find clear evidence of a structural shift toward more Japanese imports from Western Pacific developing countries. As Lawrence's analysis would have suggested, however, they find that Japanese foreign direct investment plays a key role in this shift: NIC and NIE exports seem to get into Japan largely because they originate in Japanese-controlled firms. Park and Park also find that the changes in East Asian trade patterns remain far too limited to envision the emergence of a yen trading bloc anytime soon.

Market Structure and Trade

The next three papers focus on the question of market structure in Japan, and how it may affect international trade.

Richard C. Marston uses data on pricing behavior of firms as a clue to the functioning of markets. He shows that Japanese firms engage in strong "pricing to market": cutting the yen prices of exports, but not of the same goods delivered to domestic markets, when the yen rises. This pricing to market reveals two important facts about Japanese manufacturing firms. First, the firms behave strategically, not at all like the atomistic competitors assumed in much of the empirical testing of hypotheses about trade. Second, the firms evidently are able to segment markets, charging very different prices at home and abroad.

Marston also shows that structural change has proceeded at a rapid rate within the Japanese manufacturing sector, with sharp trends in relative prices associated with differential rates of productivity growth. This observation helps explain why there appears to be a secular upward trend in the equilibrium real yen—a theme that comes back later in Jeffrey Frankel's paper.

Japan's distribution system has attracted much foreign attention. With its proliferation of small stores and many layers of wholesaling, the system appears inefficient to outsiders; it is also accused of fostering vertical relationships that effectively close the Japanese market to foreigners. Two of the papers presented here, by Takatoshi Ito and Masayoshi Maruyama and by Motoshige Itoh, examine this distribution system.

Ito and Maruyama focus on the question of efficiency. Somewhat surprisingly, they do not find much evidence of striking inefficiency: although there are many shops and many layers, the overall level of employment per unit of final sales is not out of line with other industrial countries. Nor is the retailing and distribution markup exceptionally high. In essence, Ito and Maruyama suggest that Japan's distribution system uses a different ownership structure to do pretty much the same things that are done elsewhere.

Itoh focuses instead on the question of market structure. He documents the substantial extent to which Japanese distribution does in fact engage in practices that appear noncompetitive to U.S. eyes. But he points out that many of these practices can be rationalized as responses to problems of imperfect information, especially in the context of a legal system that makes formal contracts less feasible, and long-term relationships correspondingly more important, than in the United States.

Financial Markets

In the last few years, Japan has emerged as a spectacular financial powerhouse: the world's largest investor, with a stock market that rivals or surpasses America's in value, and—very lately—a scene of wild fluctuation in asset values that belie any image of a tightly controlled society where everything is under central direction.

Two of the papers in the conference, by David M. Meerschwam and Jeffrey A. Frankel, focus on Japanese financial markets: Meerschwam on institutional structure and Frankel on prices.

Meerschwam highlights the special role, via the *keiretsu*, of Japan's banks in industrial structure. He points out that there is an important distinction between the forces that gave rise to the special role of large banks and the function that these banks play. It was to an important extent the controlled economy of early postwar Japan that pushed banks into a key role: controlled interest rates meant that access to credit became crucial to business success, leading to the predominance of industry groups clustered around banks. Yet this institutional arrangement turned out to have other benefits: because banks were uniquely situated to monitor their firms and resolve problems of information, Japanese industry was allowed to adopt a long-run view rather than to appease stockholders by focusing on the bottom line.

Meerschwam points out, however, that the traditional structure of Japanese financial markets is under strain and may indeed be on its way out. Deregulation and the opening of Japan's financial system to the outside world have undermined the automatic special role of banks, and a more Anglo-Saxon style system may be emerging. Interestingly, Meerschwam suggests that this increase in competition may not be a desirable thing, that even though firms may voluntarily move away from the old style of finance they may collectively lose as a result.

Frankel addresses instead the question of asset prices. In particular, why did Japanese land and stock prices move to such high levels in the 1980s?

Frankel first argues that the high ratio of prices to earnings in Japan can be explained to a significant degree, though not entirely, by two factors: low real interest rates and high growth prospects. He makes the important point that real interest rates internationally are not necessarily equalized by arbitrage: if a country is expected to show persistent real appreciation, then it will have a low real interest rate even in an integrated world capital market. Since this appears to be true of Japan, for reasons touched upon by Marston's paper, high asset prices should be expected.

If this is true, however, why did the boom come in the 1980s and not before? Here Frankel appeals to the institutional changes that Meerschwam identified. Under the traditional financial system, savings were channeled into business investment and were not available to bid up prices of financial assets. With the erosion of that system, the underlying reasons for high asset prices have been able to assert themselves.

Industrial and Trade Policy

The final two papers of this volume, by Masahiro Okuno-Fujiwara and Amelia Porges, treat the role of government in Japan's trade relations.

Okuno-Fujiwara traces the history of Japan's industrial policy. Echoing the discussion of financial markets, he points to the gradual evolution of that policy away from dirigisme. At one time, control over the allocation of rationed credit and foreign exchange gave the idea of "Japan, Inc." some reality. Since the early 1970s, however, the role of government guidance has shifted to something more modest and subtle. In part, government acts in ways perfectly acceptable to a neoclassical economist, attempting through such activities as technology promotion to overcome problems of external economies with their resulting divergence between private and social returns. He also emphasizes the role of government policy in helping the private sector form consistent expectations—in effect, arguing that the Japanese government is now engaged to an important extent in noncoercive indicative planning.

In the final paper of the conference, Porges takes us from the world of analytics to that of actual trade policy, with a blow-by-blow account of the trade negotiations between the United States and Japan. Her paper reminds us of the difficulty of converting academic assessments into operational demands and of the importance of interest group politics in both countries. For an American her paper is, in particular, a useful reminder that Japan is not only a major economic power but also a real country, with real politics, no more able to deliver sweeping change on demand than we are ourselves.

Lessons of the Conference

This conference was not intended to deliver immediate policy advice. Instead, it aimed to provide new evidence on the truth about Japan and its economic relationship with the United States. What did we learn? I would stress three main themes.

First, Japan *is* different. That part of the conventional wisdom that emphasizes sharp institutional differences between Japanese and U.S. markets is clearly borne out by many of the papers, in everything from the pricing behavior of exporters to the financial role of banks.

Second, in some ways Japanese difference does contribute to trade tension (which is not the same thing as saying that it is in any sense "unfair"). Japan does appear to be marked by a style of relationships between firms that makes it difficult for outsiders, including foreigners, to break in.

Third, this Japanese difference in many cases appears to make sense—that is, there are real efficiency advantages to the Japanese style of business, arising from the virtues of long-term relationships in a world of incomplete information. Even where it is commonly supposed that Japan is very inefficient, this conference showed some surprising performance. We must therefore be cautious about lecturing Japan about noncompetitive practices: they may know what they are doing.

Fourth, Japan itself is changing. Imports of manufactured goods are increasing; financial markets are becoming less distinctive. We should beware of applying stereotypes from a decade ago to the very different Japan that is now emerging.