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U.S.-Japan Economic Relations: Significance, Prospects, and Policy Options

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Summary

Japan and the United States are the two largest economic powers. Together they account for over 30% of world domestic product, for a significant portion of international trade in goods and services, and for a major portion of international investment. This economic clout makes the United States and Japan potentially powerful actors in the world economy. Economic conditions in the United States and Japan have a significant impact on the rest of the world. Furthermore, the U.S.-Japan bilateral economic relationship can influence economic conditions in other countries.

The U.S.-Japan economic relationship is very strong and mutually advantageous. The two economies are highly integrated via trade in goods and services—they are large markets for each other's exports and important sources of imports. More importantly, Japan and the United States are closely connected via capital flows. Japan is a major foreign source of financing of the U.S. national debt and will likely remain so for the foreseeable future, as the mounting U.S. debt needs to be financed and the stock of U.S. domestic savings remains insufficient to meet the demand. Japan is also a significant source of foreign private portfolio and direct investment in the United States, and the United States is the origin of much of the foreign investment in Japan.

The *relative* significance of Japan and the United States as each other's economic partner has diminished somewhat with the rise of China as an economic power. For example, China has overtaken Japan and is the largest source of foreign financing of the U.S. national debt. In addition, U.S. economic ties with Canada, Mexico, and China have deepened, further eroding the direct relevance of Japan. Nevertheless, analyses of trade and other economic data suggest that the bilateral relationship remains important, and policy leaders of both countries face the challenge of how to manage it.

During the last decade policy leaders seem to have made a deliberate effort to drastically reduce the friction that prevailed in the economic relationship. On the one hand, this calmer environment has stabilized the bilateral relationship and permitted the two countries to focus their attention on other issues of mutual interest, such as national security. On the other hand, as some have argued, the friendlier environment masks serious problems that require more attention, such as continuing Japanese failure to resolve long-standing market access barriers to U.S. exports of autos and auto parts and flat glass and the failure of the two countries to reduce bilateral trade imbalances. Failure to resolve any of these outstanding issues could cause heightened friction between the two countries.

U.S.-Japan economic relations will likely be dominated directly or indirectly by the economic problems the two countries are now facing. Both Japan and the United States are grappling with the effects of the global financial crisis that has resulted in an economic downturn. Both the United States and Japan have shown signs of economic recovery.

Other issues regarding U.S.-Japan economic relations may emerge on the agenda of the 111th Congress. U.S. and Japanese leaders have several options on how to manage their relationship, including stronger reliance on the World Trade Organization; special bilateral negotiating frameworks and agreements; or a free trade agreement. Each option has its advantages and drawbacks, and they are not necessarily mutually exclusive.

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Japan and the United States are the two largest economic powers. Together they account for over 30% of world domestic product (2009 estimate). This economic clout makes the United States and Japan powerful forces that affect each other's economic conditions and the conditions of other countries. Economic conditions in the United States and Japan have a significant impact on the rest of the world. Furthermore, the U.S.-Japan bilateral economic relationship itself can influence economic conditions in other countries.

The shape and tone of the U.S.-Japan bilateral relationship have changed recently, with relations very tense during some periods and calm during others. The means and manner by which the United States and Japan have managed their economic relationship has also changed over time. Yet, the two countries remain very important economic partners, accounting for significant shares of each other's foreign trade and investment, even though their relative significance has declined. The global financial crisis and economic downturn have added another dimension to the relationship as the two countries grapple with the severe impact of the crisis on their respective economies and simultaneously work with their mutual partners in the G-20 to coordinate a multilateral response.

The U.S.-Japan economic relationship is important to U.S. national interests and to the U.S. Congress. It has been the subject of oversight hearings and trade legislation, and the Congress plays a critical role in shaping U.S. economic policy toward Japan. To assist Congress in fulfilling its responsibilities, this report explores (1) the significance and state of U.S.-Japan economic ties; (2) how the ties have changed over time; and (3) what the possible options for managing the relationship might be.

An Overview of U.S.-Japan Economic Trends

The U.S. and Japanese economies remain closely intertwined through trade and capital flows. U.S. and Japanese political leaders have not always given the U.S.-Japan relationship the priority commensurate with its economic importance; nevertheless, the data and other indicators suggest that the relationship bears attention.

The Japanese and U.S. Economies

The U.S. and Japanese economies are in some respects very similar. They are large industrialized economies that have provided their residents with a high standard of living. However, as **Table 1** points out, they are very different in some critical ways. The U.S. economy is roughly 2½ times larger than Japan's both on a nominal and purchasing power parity (PPP) basis.[1] The Japanese standard of living is slightly lower than the U.S. standard of living measured on a nominal per capita/GDP basis and even lower when measured on a PPP per capita/GDP basis. (The latter measurement reflects the high cost in Japan for food, fuel and other basic necessities compared to the United States.) Japan has also endured slow economic growth or even recessions during the past decade while U.S. economic growth had been generally robust, at least until recently. The U.S. average annual GDP growth rate during the last 10 years (2000-2009) has been more than 2

[1] Purchasing power parity (PPP) measurements are the value of foreign currencies in U.S. dollars based on the actual purchasing power of such currency. The PPP exchange rate is then used to convert foreign economic data in national currencies into U.S. dollars.

times that of Japan's. Japan has been especially hit hard by the global economic downturn. In 2009, its GDP declined 5.1%, while the United States' GDP declined 2.5%.

Exports are slightly more important to the Japanese economy than are imports as measured as ratios to GDP, while imports are more significant than exports in the U.S. economy. The United States continually incurs current account deficits. Japan had been earning current account surpluses, although the surpluses have been decreasing due to diminishing demand for Japan's exports (a result of the global economic downturn).

Japan has continually exceeded the United States in terms of savings. The gross national savings rate in Japan is more than 2½ times that of the United States (23% vs. 9%). Many economists consider the strong propensity to save in Japan relative to the United States as the primary reason why the United States has incurred current account trade deficits with Japan for many years and why Japan continues to be a major net creditor while the United States is a net debtor. At the same time, Japan has built up a huge volume of public debt, and its debt burden as a ratio of GDP is more than twice that of the United States. Japan's public debt has soared in the last decade as it has attempted to stimulate growth with extra government spending.

Table 1. Key Comparative Economic Indicators for the United States and Japan

	Japan	United States
GDP (2009)		
-Nominal (billions of $U.S.)	5,073.4	14,265
-PPP (billions of $U.S.)	4,144	14,265
Per Capita GDP (2009)		
-Nominal	39,920	46,950
-PPP (U.S. Dollars)	32,610	46,950
Real GDP Growth Rates (2009)	-5.1%	-2.5%
Average Annual Real GDP Growth Rate (2000-2009)	0.7 %	1.9%
Exports as % GDP (2009)	12.5%	11.1%
Imports as % GDP (2009)	12.2%	13.9%
Current Account Balance as % of GDP (2009)	2.8%	-2.8%
Gross National Savings Rate (2009)	23%	9%
Recorded Unemployment Rates (2009)	5.1%	9.3%
Public Debt/GDP (2009)	189.3%	47.3%

Source: Economist Intelligence Unit

U.S.-Japanese Trade in Goods and Services

U.S.-Japanese bilateral trade in goods and services has grown over time, although recently the level of bilateral trade turnover has plateaued. As **Table 2** shows, U.S.-Japan total trade in goods attained a record level in 2000. U.S. exports to Japan dropped about 21% from $64.9 billion in 2000 to $51.4 billion in 2002, but have been increasing since then to $62.7 billion in 2007 and to $66.6 billion in 2008. U.S. imports have increased recently from $118.0 billion in 2003 to $145.4 billion in 2007 but declined to $139.5 billion in 2008.

U.S. imports from Japan are concentrated within three main categories. About three-quarters of those imports have consisted of passenger cars and parts; computers and components; office machinery parts; and electrical machinery (primarily video cameras). U.S. exports to Japan are much more diverse, but a major portion of those exports are in computers and components; gas turbines (turbojets, turbo-propellers, etc); office machinery parts; electrical machinery (integrated circuits and electrical apparatus for line telephone systems); optical and medical equipment; and agricultural products such as wheat and meat.

Table 2. U.S. Merchandise Trade with Japan, 1998-2009

(billions of $ U.S.)

Year	U.S. Exports	U.S. Imports	Trade Turnover	U.S. Balances
1998	57.9	122.0	179.9	–64.1
1999	57.5	131.4	188.9	–73.9
2000	64.9	146.5	211.4	–81.6
2001	57.5	126.5	184.0	–69.0
2002	51.4	121.4	172.8	–70.0
2003	52.1	118.0	170.1	–66.0
2004	54.4	129.6	184.0	–75.2
2005	55.4	138.1	193.5	–82.7
2006	59.6	148.2	207.8	–88.6
2007	62.7	145.5	208.2	–82.8
2008	66.6	139.2	205.8	-72.3
2009	51.2	95.9	147.1	-44.8

Source: U.S. Department of Commerce, Bureau of the Census.

Although Japan remains important economically to the United States, its importance has slid as it has been edged out by other trade partners. Japan was the United States' fourth-largest merchandise export market (behind Canada, Mexico, and China) and the fourth-largest source for U.S. merchandise imports (behind Canada, Mexico, and China) by the end of 2009. These numbers probably underestimate the importance of the United States to Japan's trade since a significant portion of Japanese exports to China are used as inputs to China's exports to the United States and, therefore, are dependent on U.S. demand for China's exports.

At one time Japan was the largest source of foreign direct investment in the United States, but by 2006 had fallen to second place, behind the United Kingdom, where it remained at the end of 2008. For many years, the United States was Japan's largest export market but became the second largest in 2009 (next to China). The United States was second-largest source of imports as of the end of 2009. The global economic downturn has had a significant impact on U.S.-Japan trade. In 2009, U.S. exports declined by 23.1% from 2008, and imports from Japan declined by 31.1 % causing the U.S. bilateral deficit with Japan to decrease to $44.8 billion. (See **Table 2**.)

The emergence of China and other East Asian countries has played a role in the declining significance of the United States in Japan's trade. In the last decade, Japanese trade flows have shifted decidedly towards East Asia from the United States. In 1994, 38.6% of Japanese exports went to and 33.0% of Japanese imports came from 9 of the largest economies in East Asia.[2] By 2008, 46.8% of Japanese exports and 37.9% of Japanese imports were with the nine countries of East Asia. China is the fastest-growing Japanese trade partner.

Similarly, the geographic pattern of U.S. trade has shifted. Mexico and, to a lesser degree, China have surpassed Japan in U.S. trade as noted above.

U.S.-Japan trade in services has increased, at least on the U.S. import side, although it remains relatively modest as of 2008 (the latest data available.)[3] (See **Table 3**.) The United States exports a variety of services to Japan in the form of travel services, passenger fares, and "other transportation;" royalties and licensing fees; and other private services. U.S. imports of services from Japan consisted mostly of transportation other than passenger fees, royalties and licensing fees, and other private services. The United States has realized surpluses in its bilateral trade in services with Japan.

Table 3. U.S. Trade in Services with Japan, 1998-2008

($ in billions)

Year	U.S. Exports	U.S. Imports	Trade Turnover	U.S. Balances
1998	30.7	14.8	45.5	15.9
1999	31.9	17.4	49.3	14.5
2000	33.7	18.8	52.5	14.9
2001	30.5	18.0	48.5	12.5
2002	30.4	18.9	49.3	11.5
2003	30.1	20.0	50.1	10.2
2004	36.0	21.3	57.3	14.8
2005	42.5	23.8	66.3	18.7
2006	42.0	25.5	67.5	16.5
2007	41.2	26.2	67.4	15.0
2008	43.2	27.3	70.5	15.9

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

U.S.-Japan Bilateral Investment

Along with trade in goods and services, foreign direct (investments in manufacturing facilities, businesses, and real estate) and portfolio investments (investments in government securities, corporate stocks and bonds, and bank deposits) between residents of the United States and Japan also define the economic relationship. The value of portfolio and direct investments between the United States and Japan exceeds the value of trade in goods and services. In addition,

[2] China, Hong Kong, Indonesia, South Korea, Malaysia, Philippines, Singapore, Thailand, and Taiwan.

[3] The data capture "cross-border" trade in services. Because they are intangible, most services are bought and sold where the buyer and seller are located in close proximity, for example, sold by a foreign-owned company in the country of the buyer. The data, therefore, under report the volume of trade in services.

investments, particularly foreign direct investments (**Table 4**) signify a long-term financial commitment on the part of the investor.

Foreign direct investment (FDI) consists of investments in real estate, manufacturing plants, and retail facilities, in which the foreign investor owns 10% or more of the entity. FDI can be new establishments or mergers with or acquisitions of already established locally based enterprises. Investors seek to take advantage of skilled labor or other resources of the local economy, to produce goods or services tailored to the local market, to avoid foreign trade barriers, and for other reasons.

Table 4. U.S.-Japanese Foreign Direct Investment (FDI) Positions, 1997-2007

Historical-Cost Basis
($ in billions)

	Japanese FDI in U.S.	U.S. FDI in Japan
1997	125.0	33.9
1998	134.3	41.4
1999	153.8	55.1
2000	159.7	57.1
2001	149.9	55.7
2002	147.4	66.5
2003	157.2	57.8
2004	175.7	68.1
2005	190.3	75.5
2006	211.0	92.4
2007	230.5	81.9
2008	259.6	79.2

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Note: Figures are cumulative FDI.

The United States has consistently been the largest source of FDI in Japan. From 1997 to 2005, U.S. FDI in Japan more than doubled, albeit from a low base of $33.9 billion to $92.4 billion. The sharp increase in investments was largely the result of acquisitions by U.S. firms of Japanese entities that were facing bankruptcy, rather than investments. However, $79.2 billion in U.S. FDI in Japan in 2008 (latest data available) pales in comparison to U.S. FDI in some other, smaller, fully industrialized countries. For example, U.S. FDI in 2008 totaled $442.9 billion in the Netherlands and $420.9 billion in the United Kingdom.[4] The Japanese economy has been relatively "closed" to foreign investment, and the level of foreign direct investment in Japan consistently ranks among the lowest of industrialized countries.

Over the years, Japanese investors have established a strong presence in the United States. Japanese FDI in the United States surged in the 1980s and continued to increase in the 1990s. In the 1980s, Japanese investors acquired such high-profile U.S. assets as Columbia Pictures,

[4] U.S. Department of Commerce, Bureau of Economic Analysis.

Rockefeller Center, and Pebble Beach Golf Course. These investments followed surges in Japanese investments in the United States by Japanese consumer electronics firms and auto producers. (Many of these acquisitions were not profitable for Japanese investors.) The rapid increase of the investments and their high visibility generated concerns in the United States of Japan "buying up the United States." By 2000, the level of Japanese FDI in the United States rose to $159.7 billion but declined to $147.4.0 billion by 2002. The level of Japan's FDI in the United States has increased since, reaching $259.6 in 2008. In 2006 (latest data available), Japanese majority-owned affiliates in the United States employed 631,000U.S. workers.[5]

In the 1980s, Japan became the largest source of FDI in the United States, surpassing the United Kingdom, the traditional leader. By 2002, Japan had dropped to the fourth-largest source of FDI, far behind the United Kingdom and France, and slightly behind the Netherlands. However, in 2004, its ranking reached number two behind the United Kingdom and remained there in 2008.[6]

In addition to foreign direct investment, substantial amounts of capital flow between the United States and Japan in the form of portfolio investments. At the end of 2008, U.S. investors held $356.6 billion in Japanese corporate stocks and $48.6 billion in Japanese bonds. Japanese investors held $153.9 billion in U.S. corporate stocks and $268.2 billion in U.S. corporate bonds.[7]

Japanese investors are major private foreign holders of U.S. Treasury securities that finance the U.S. national debt, and their importance has soared over the last few years. By the end of 2009, Japanese residents held $765.7 billion in U.S. securities. At one time, Japanese investors were the largest foreign holders of U.S. Treasury securities, but beginning in September 2008, residents in China surpassed them and, as of the end of 2009, held $894.8 billion in U.S. Treasury securities.[8] Japanese holdings of U.S. Treasury securities underscore the debtor/creditor link between the United States and Japan. As the U.S. government continues to incur budget deficits and maintains a low national savings rate, the United States has had to rely increasingly on foreign creditors to finance the rising national debt. This has some potentially problematic implications for U.S. interest rates. For example, if Japanese investors decided to switch their foreign investment from U.S. Treasury securities to euro-denominated securities, or if Japan's savings rate should decline as older Japanese citizens spend down their savings, and capital begins to flow back to Japan, U.S. interest rates would likely rise, all other factors remaining unchanged. The volume of Japanese U.S. Treasury security holdings has been declining somewhat over the last two years.

The Bilateral Economic Relationship and Shifting U.S. and Japanese Policy Priorities

By necessity, the United States and Japan had long given their bilateral economic relationship high priority. For Japan the importance of the relationship has been rooted in the emergence of the United States as the world's largest economic power; Japan's dependence on the United States for national security, especially during the Cold War; the dependence of Japanese manufacturing industries—autos, consumer electronics, and others—on exports to the United States; and the

5 Ibid.

6 Ibid.

7 *Survey of Current Business.* July 2008, 15-16.

8 U.S. Department of the Treasury. http://www.ustreas.gov/tic/.

reliance of reform-minded Japanese political leaders on U.S. pressure, *gaiatsu*, to press for economic reforms in a political system that strongly protects the status quo.

For the United States, the importance of the economic relationship with Japan has been grounded in its reliance on Japan as a critical ally; the emergence of Japan in the post-World War II period as an economic power in East Asia and the second-largest economy in the world; the advancing competition from Japanese manufacturers in industries, for example autos and steel, which employ large numbers of U.S. workers; the rising trade deficits with Japan; Japan's emergence as a major source of investment in the United States; and Japanese government policies that have protected vulnerable sectors and assisted exporters, often at the expense of U.S. competitors.

For many years, the bilateral economic relationship was the centerpiece of U.S. and Japanese foreign economic agendas, and Japanese trade strongly influenced the making of overall U.S. trade policy. Many scholarly and popular books and journals were written on the subject.[9]

One reason for the shift in priorities may be the rise of China as a trade power. Since 2000, the U.S. bilateral trade deficit with China has exceeded the deficit with Japan, and the gap between the two deficits continues to grow. In 2008, the U.S. trade deficit with Japan was $72.7 billion, the one with China was $266.3 billion. The growing deficit with China has forced U.S. policymakers to address actions by China that U.S. companies have asserted are unfair. These include barriers to U.S. exports, inadequate protection of intellectual property rights, an arguably undervalued exchange rate, and sales of products in the United States at less than fair value. For Japan, China has emerged as a major economic competitor and/or partner in the region requiring more attention.

Other possible reasons for the shift in policy priorities might include the following:

- Foreign policy and national security concerns have trumped commercial concerns especially after the events of September 11, 2001, and the increasing instability on the Korean peninsula caused by North Korea's nuclear ambitions.
- The establishment in 1995 of the World Trade Organization and a restructured dispute settlement body has lessened the scope for U.S. unilateral trade pressures to open Japan's market further.
- The emergence also of a reform-oriented government under former Prime Minister Koizumi diminished the perception that heavy-handed *gaiatsu* is an effective policy to influence Japanese economic policy. However, some observers have raised concerns that Koizumi's successors have not been as committed to economic reform.
- Japan's success in the 1990s at resisting U.S. pressure may have created a sense that U.S. influence over Japan was limited.

The United States and Japan have been forging economic relations with other countries and regions through free trade agreements (FTAs), which has reduced the focus on their own bilateral relations. In the last few years, the United States has entered into FTAs with Jordan (2001), Chile (2004), Singapore (2004), Australia (2005), Morocco (2006), Bahrain (2006), the Dominican

[9] For example, Clyde V. Prestowitz, *Trading Places: How We Allowed Japan to Take the Lead* (New York: Basic Books, 1988).

Republic and Central America (DR-CAFTA, 2007), Oman (2009) and Peru (2009). Other agreements have either been completed or are still under negotiation. The United States under the Bush Administration had also launched initiatives with the ASEAN members—the Enterprise for ASEAN Initiative—and countries of the Middle East—the Middle East Free Trade Initiative. The FTAs were part of the Bush Administration's "competitive liberalization" trade strategy which focuses on pursuing trade agreements on multiple fronts.

Japan entered into its first FTA with Singapore in November 2002. In addition to the Singapore agreement, Japan is building its economic presence in East Asia by negotiating FTAs with South Korea, Malaysia, Thailand, the Philippines, and Mexico.[10]

The agreement with Mexico is noteworthy because Japan had to make concessions on agricultural imports before Mexico would conclude the agreement. Japan avoided this step with Singapore since agricultural trade is not an important issue between the two countries. Japan was compelled to make the concessions and conclude the agreement because Japanese exporters face high tariff barriers in Mexico and have been at a competitive disadvantage with U.S. and EU producers who do not face similarly high tariffs under FTAs with Mexico.

However, the economic problems in Japan and United States associated with the financial crisis and recession and how the two countries deal with those problems will likely dominate their bilateral economic agenda for the foreseeable future. Japan has been hit particularly hard by the financial crisis and subsequent economic downturn. Japan's gross domestic product (GDP) declined 0.7% in 2008, and an estimated 5.5% in 2009. The Economist Intelligence Unit forecasts a modest recovery of 1.4% in 2010. The value of the yen has hit 13-year highs in terms of the U.S. dollar, which will adversely affect Japanese exports to the United States and other countries, contributing to the downturn in Japanese economic growth. Less than three years ago, the yen was valued at $1=¥124. As of February 18, 2010, it was $1=¥91.

The Bilateral Negotiating Framework

On June 30, 2001, President Bush and then-Prime Minister Koizumi announced the formation of a new bilateral framework, the "U.S.-Japan Economic Partnership for Growth" (The Economic Partnership). In so doing, the Bush Administration continued a tradition of creating special frameworks as mechanisms for discussing bilateral economic issues with Japan, a unique approach in U.S. trade policy.

Negotiating Precedents

The special bilateral frameworks have served several purposes: to define the issues that plague the relationship; to establish goals and methodologies to resolve problems; and to create the bureaucratic structures and momentum to launch and maintain the negotiations. The frameworks shared characteristics that reflected the dominance of the United States in the relationship and the nature of the trade issues:

[10] For more information on Japan's FTAs, see CRS Report RL33044, *Japan's Free Trade Agreement Program*, by Raymond J. Ahearn.

- Their objectives were largely one-way: Japan was to remove obstacles to trade and investment, while the United States was not required to make concessions.
- They were intended to pressure Japan to reduce or remove government policies or practices that acted as informal barriers to imports and investment.
- They contained an explicit or implicit penalty for Japan, such as restrictions on Japanese exporters' access to U.S. markets.
- They were largely outside the General Agreement on Tariffs and Trade (GATT)/WTO trade structure which did not cover targeted Japanese policies and practices.
- They were designed to affect areas that would reap the greatest benefits to U.S. exporters and investors even though the most-favored-nation (MFN) principle that binds all GATT/WTO members by requiring that the concessions Japan made should apply to its trade with all WTO members.

The Reagan Administration introduced the first multi-sector negotiating framework—the Market-Oriented Sector-Selective (MOSS) talks with Japan in March 1985. The MOSS talks covered Japanese trade in five areas: telecommunications; medical equipment and pharmaceuticals; forestry products; electronics; and auto parts.[11] In 1989, President George H. W. Bush launched with Prime Minister Uno the Structural Impediments Initiative (SII) that targeted a broad range of Japanese macroeconomic policies, practices and other structural factors that underlay the persistent U.S.-Japan trade imbalances, focusing on the inability of U.S. exporters and investors to penetrate or increase their presence in the Japanese market.

In 1993, the Clinton Administration negotiated the United States-Japan Framework for a New Economic Partnership. At the insistence of the Clinton Administration, "objective criteria" were to be used to determine whether Japan was fulfilling its obligations under the framework. This element proved highly controversial, and the two countries never agreed on the role the "objective criteria" would play or, for that matter, what they would be. Japan did not want to be bound by what it termed "managed trade." Nevertheless, by June 1997, the United States and Japan had addressed, if not resolved, the major issues under the Framework. In its place, the Clinton Administration got Japan to agree to another, more loosely shaped format, the Enhanced Initiative on Deregulation and Competition Policy (the Enhanced Initiative). This format did not have the specific results-oriented elements of the previous framework.

The Reagan, George H.W. Bush, and Clinton Administrations also negotiated sector-specific trade issues with Japan outside of the framework format. For example, the Reagan Administration obtained so-called voluntary export restraint (VER) agreements under which Japan agreed to limit exports of autos and steel products to the United States. In 1985, the United States and Japan (along with other G7 industrialized countries) negotiated the Plaza Accord to promote realignment of the dollar and the yen. Other agreements were directed at market access in Japan for constructions services, telecommunications equipment, certain agricultural products, autos and auto parts, and flat glass, among others.

Of particular note is the 1986 semiconductor agreement in which the Reagan Administration got Japan to agree to cease dumping semiconductors in the United States and to open its market to

[11] For more details about the history of the special U.S.-Japan bilateral frameworks, see **Appendix**.

U.S. exporters of semiconductors. The semiconductor agreement was a milestone in U.S.-Japanese trade relations because it included in a side-letter a minimum target of 20% share of the Japanese market for U.S. exporters of semiconductors to attain. The United States imposed sanctions in 1987 in the form of higher tariffs on imports of selected Japanese electronic products when the share did not reach 20%. The semiconductor agreement is considered to have been the model for the objective criteria measures that the Clinton Administration demanded in the framework it used with Japan. The sanctions that resulted from the semiconductor agreement were also a reason Japan strongly resisted the use of objective criteria. In 1991, the semiconductor agreement was renewed with the 20% share embedded directly in the agreement language. It expired in 1996 and was replaced by a pact among several countries to monitor semiconductor trade.

The Economic Partnership

The Bush Administration's Economic Partnership framework closely followed on the Clinton Enhanced Initiative. The Economic Partnership emphasized macroeconomic and structural issues that have hampered Japanese economic growth but also examines issues of the U.S. economy.

The Economic Partnership consisted of several initiatives or dialogues to include participation from subcabinet-level leaders from both governments and participation from members of the business communities and other non-government sectors from both countries. The U.S.-Japan Subcabinet Economic Dialogue provided overall direction for the Economic Partnership. Other elements of the Economic Partnership included the Regulatory Reform and Competition Policy Initiative (with working groups on telecommunications, information technologies, energy, and medical devices and pharmaceuticals, plus a cross-sectoral working group); the Financial Dialogue, which examined such issues as banking reform; the Investment Initiative, which discussed requirements to improve the investment climate in Japan; and the Trade Forum, which operated to resolve sector-specific trade issues, to catch potential problems before they get worse, and to monitor sector-specific agreements already in effect. Each one of these elements contributed to an annual report to the President and the Prime Minister in which participants record progress and make recommendations for the coming year. The Obama Administration has continued this initiative. The two sides produced their eighth report in July 2009.

The WTO Dispute Settlement Mechanism

In addition to negotiations under the Economic Partnership framework, the United States and Japan are using the dispute settlement mechanism in the World Trade Organization (WTO) more frequently to resolve bilateral issues. In so doing, the United States and Japan have helped to depoliticize their trade disagreements, leaving it to panel members selected from trading partner nations to adjudicate the disputes. Furthermore, the WTO has provided a forum in which Japan has felt comfortable challenging U.S. trade practices.

Increased reliance on the WTO has reflected a major shift in Japan's strategy in dealing with the United States in trade. In 1995, Japan filed a dispute with the WTO as a counter-complaint against a U.S. complaint against Japan on the sale of autos and auto parts. (For details, see **Appendix**.) The two countries reached a resolution outside the WTO, but it was the first time that Japan had challenged the United States rather than acceding to U.S. demands. Japan was emboldened to shift its strategy in 1997 when the WTO ruled against the United States on its complaint against Japan regarding the marketing of Kodak and Fuji film in Japan.[12] However, the United States has also challenged Japan successfully in the WTO. These and other major pending issues in U.S.-Japan economic relations are discussed below.

Issues and Prospects

Recently, U.S.-Japan economic ties have become less contentious. Nevertheless, they still face many complex issues. Some of these issues are long-standing while others have developed more recently.

Product-Specific Issues

A number of product-specific issues have lingered stubbornly. They largely involve Japanese barriers and continue to be discussed under product agreements signed by previous U.S. and Japanese administrations.

Agriculture

In December 2003, Japan imposed a ban on imported U.S. beef in response to the discovery of the first U.S. case of bovine spongiform encephalopathy (BSE or "mad cow disease") in Washington state. In the months before the diagnosis in the United States, nearly a dozen Japanese cows infected with BSE had been discovered, creating a scandal over the Agricultural Ministry's handling of the issue (several more Japanese BSE cases have since emerged). Japan had retained the ban despite ongoing negotiations and public pressure from Bush Administration officials, a reported framework agreement (issued jointly by both governments) in October 2004 to end it, and periodic assurances afterward by Japanese officials to their U.S. counterparts that it would be lifted soon.

In December 2005 Japan lifted the ban after many months of bilateral negotiations but re-imposed it in January 2006 after Japanese government inspectors found bone material among the first beef shipments to have arrived from the United States after the ban was lifted. The presence of the bone material violated the procedures U.S. and Japanese officials had agreed upon that allowed the resumption of the U.S. beef shipments in the first place. The then-U.S. Secretary of Agriculture Johanns expressed regret that the prohibited material had entered the shipments.

In July 2006, Japan announced it would resume imports of U.S. beef from cattle 20 months old or younger. While praising the decision, some officials have called on Japan to broaden the procedures to include beef from older cattle. The first shipments arrived in August 2006. Members of Congress have pressed Japan to lift restrictions on imports of U.S. beef further. On May 27, 2009, the Japan Ministry of Health, Labor, and Welfare and the Ministry of Agriculture, Forestry, and Fisheries reportedly were ready to ask the Food Safety Commission to determine whether it would relax restrictions and allow U.S. beef from cattle younger than 30 months to enter Japan, a decision that could take about six months to be rendered.[13] In a meeting with

[12] Saaida M. Pekkanen, "The Politics of Japan's WTO Strategies," *Orbis*, Winter 2004, pp. 135-147.

[13] *International Trade Daily*. May 28, 2009.

Japan's Minister of Agriculture, Hirotaka Akamatsu, U.S. Agriculture Secretary Vilsack and USTR Kirk urged Japan to move ahead with reducing the restrictions on beef imports.[14]

Market Access

In 1995 the United States and Japan concluded an agreement to improve access of foreign *flat glass* (used in the making of car windows, for example) to the Japanese domestic market. The agreement was in response to complaints by U.S. producers that they cannot enter a market which has been effectively controlled by three Japanese companies. U.S. manufacturers have alleged that a combination of anticompetitive private-sector business practices and Japanese government regulations restricted entry into the market. Under the 1995 agreement the Japanese government pledged to revise building regulations to encourage the use of foreign-produced glass and to more vigorously enforce the Anti-Monopoly Law against anticompetitive practices. Japanese private sector consumers and wholesalers pledged to broaden their source of supplies to include foreign glass. The agreement expired at the end of 1999. Negotiations to extend the agreement failed. The United States still raises concerns about anticompetitive conditions in the Japanese flat glass market under the Trade Forum of the Economic Partnership framework.

On December 3, 2000, the five-year bilateral pact on trade in *autos and auto parts* expired. Under the agreement Japan agreed to change regulations that the United States claimed discouraged the import of U.S.-made cars and auto parts. The United States pressed Japan to renew the agreement, but Japan refused, claiming that increases in Japanese auto parts imports made the agreement obsolete. The United States insisted on a forum to continue to raise and discuss market access in Japan, particularly regulations and practices that continue to keep imports in Japan at low levels. In October 2001, the two countries established the Automotive Consultative Group (ACG). U.S. officials pressed Japan to improve transparency in regulating the market and have cited declining Japanese imports of foreign-made autos and auto parts. The issues were also part of the broader Economic Partnership framework.

The U.S. auto industry and a bipartisan group of Member of Congress have raised concerns that the Japanese government is implementing its *eco-car program*, a program to encourage the purchase of low-emissions and fuel-efficient cars, in a way that unfairly discriminates against U.S.-made vehicles. Under the program, which went into effect on June 19, 2009, Japanese car buyers can obtain tax incentives if they turn in a car at least 13 years old and purchase one that meets Japan's fuel efficiency standards, and are eligible for an additional tax break if they purchase a car that exceeds those standards by at least 15%. While not explicitly disqualifying U.S.-made cars or other imported vehicles, the program did disqualify cars that were imported under the preferential handling program (PHP). The Japanese government implemented the PHP in 1986 to allow foreign models that are imported in small volumes to circumvent Japanese fuel emissions and fuel efficiency certification procedures. Since U.S.-made cars enter through that program, they would have been disqualified from the incentive program.[15]

Responding to U.S. concerns, Japan announced on January 19, 2010, that cars imported under the PHP program would be eligible for the program if they met Japan's fuel efficiency standards based on their country's testing procedures. Japan subsequently listed eight cars that would be

[14] *Inside U.S. Trade.* October 16, 2009.

[15] *International Trade Reporter*. February 11, 2010.

eligible based on U.S. Environmental Protection Agency (EPA) "city mileage" measurements. While welcoming Japan's decision as a welcome first step, the U.S. auto industry and some Members of Congress have argued that using city mileage measurements, rather than combined city/highway measurements, unnecessarily restricts the number of models that would be eligible. They have requested that Japan adopt the city/highway mileage standard in determining eligibility. The program is due to expire on March 31, 2010, but may be extended to the end of September.[16]

Another auto-related issue that could have broader U.S. trade implications is the spate of *Toyota vehicle recalls* in the United States and congressional hearings on the subject. While strictly an auto industry issue, there have been reports that some in Japan view the focus on Toyota as an Obama Administration act of displeasure for how the Japanese government has been handling the issue of the U.S. base on Okinawa. Others have suggested that the Obama Administration is using pressure against Toyota to boost sales of GM and Chrysler cars, two companies in which the government has financial stakes at the moment. Officials of Toyota USA have stated that the U.S. government has acted fairly in the recall issue.[17]

Services

Market access in Japan for U.S. and other foreign *insurance* providers has been the subject of bilateral trade agreements and discussion for some time. Current U.S. concerns center around making sure that Japan adheres to its agreements with the United States, especially as Japan's domestic insurance industry and government regulations of the industry are restructured. Specifically, American firms have complained that little public information is available on insurance regulations, how those regulations are developed, and how to get approval for doing business in Japan. They also assert that government regulations favor insurance companies that are tied to business conglomerates—the keiretsu—making it difficult for foreign companies to enter the market.

The United States and Japan concluded agreements in 1994 and 1996 on access to the Japanese market for U.S. providers of life and non-life insurance and also on maintaining competitive conditions for foreign providers in the specialty insurance market—cancer insurance, hospitalization, nursing care, and personal accident insurance. U.S. and Japanese officials continue to meet under those two agreements, and U.S. providers have been able to expand their presence in Japan under them, according to the Office of the U.S. Trade Representative (USTR).

However, the United States has raised concerns about Kampo, the government-owned insurance company under the Japan Postal Service, which offers insurance services that directly compete with U.S. and other privately owned providers. The United States has also raised questions about the activities of regulated and unregulated insurance cooperatives, kyosai, claiming that these entities do not have to adhere to the same regulations that bind traditional private insurance companies, creating an unfair competitive advantage. A Japanese government privatization framework released in July 2006 generated statements from the American Chamber of Commerce in Japan and from the American Council of Insurers arguing that the privatization plan would allow Kampo to compete with foreign insurance providers by offering new products before it has

[16] *Inside U.S. Trade.*

[17] Komori, Yoshihisa. Potential Negative Impact of Testimony by Toyota President on Japan-U.S. Security Arrangements. *Sankei*. February 25, 2010.

been completely privatized. On October 1, 2007, the Japanese government began the privatization, a process that is expected to last 10 years. However, as of late October 2009, the recently elected government led by the Democratic Party of Japan (DPJ) has taken steps, including proposing legislation that could halt, if not reverse, at least some aspects of the privatization.[18] It is unclear at this point how these initiatives might affect U.S. insurance providers.

Japanese government procurement of *construction services* has been another long-running issue. In 1994, Japan agreed under the U.S.-Japan Public Works Agreement to adhere to transparent procedures in soliciting bids for public construction projects above a certain value threshold. The United States has complained that Japanese construction companies have been allowed to collude in submitting bids (called *dango* in Japanese) restricting competition from U.S. and other outside construction companies. The United States has argued that these practices continue despite the agreement and has urged the Japanese government to clamp down on them. Under a separate agreement, the 1991 U.S.-Japan Major Projects Arrangement, Japan agreed to follow transparent procedures on specific projects. The United States has urged Japan to broaden the coverage to include all projects. Despite some progress, market access in public procurement of construction services will likely continue to be an issue.

Overarching Issues

For more than a decade, U.S.-Japanese bilateral economic discussions have concentrated less on the product-specific issues and more on fundamental factors that cut across many aspects of the U.S. and Japanese economies. The two countries have been addressing these issues within the Economic Partnership framework.[19]

U.S. Concerns

Many of the issues of concern to the United States fall under Japanese government regulations. Regulatory reform in Japan is not a new issue for the United States but has gained prominence in the last decade. Government regulations underlie many of the problems U.S. firms have with Japan. Some of these regulations are products of the immediate post-World War II era, when Japan was rebuilding its economy. Others came later. These regulations have contributed to inefficiency and low productivity in some economic sectors. They have been a factor in the limited choices that Japanese consumers have had in food and other products and also have resulted in the extremely high prices that Japanese residents have historically paid for many necessities.

Japanese policymakers have recognized the adverse economic effects of government regulations but have had difficulty in streamlining them. Recent Japanese governments have undertaken deregulation and have succeeded somewhat. The government of Prime Minister Koizumi initiated

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[18] *Inside U.S. Trade.* October 30, 2009.

[19] The following discussion reflects the recommendations of the U.S. Government and the Japanese Government under the Economic Partnership. See *Annual Reform Recommendations from the Government of the United States to the Government of Japan under the U.S.-Japan Regulatory Reform and Competition Policy Initiative* (October 14, 2004), at http://www.mac.doc.gov/japan/source/menu/dereg/rri.10-14-2004.pdf; and *Recommendations by the Government of Japan to the Government of the United States Regarding Regulatory Reform and Competition Policy* (October 14, 2004), at http://www.mofa.go.jp/region/n-america/us/report0410-1.pdf.

a program of Special Zones for Structural Reform throughout Japan that encourage deregulation in local areas. U.S. firms have been able to participate in the zones. But, in many cases, reformers run up against the powerful elements of the permanent bureaucracies of the ministries—Ministry of Finance, Ministry of Agriculture, and Ministry of Construction—that implement the regulations and that would lose authority if extensive deregulation were to take place.

The United States has focused its recommendations to Japan on the following areas:

- In *telecommunications*, the United States has argued, among other things, that Nippon Telephone and Telegraph (NTT), which has near monopoly control over land lines, charges extraordinarily high rates for competitive companies to gain access to communications lines and for competitive wireless subscribers to terminate calls to land-line recipients. The United States has pressed the Japanese government to be less biased toward NTT in developing and implementing regulations.
- Regarding *information technologies*, the United States has pressed Japan to extend copyright protection for older sound recordings, to promote electronic commerce (e-commerce), and to encourage competition in soliciting bids for government procurement of information technologies.
- In the *energy* sector, the United States has recommended that Japan pursue liberalization of its power industry in order to promote competition and to reduce costs. Japan should also ensure transparency and fairness when regulating activities in the industry, according to the United States.
- Japanese government procurement of *medical devices and pharmaceuticals* continues to be an issue for the United States. U.S. negotiators press their Japanese counterparts to take into account the value of innovative drugs when determining eligibility of drugs for government reimbursement to patients. U.S. companies claim that their pharmaceuticals tend to cost more than generic drugs because they are the latest innovations. The United States would also like Japan to accelerate the approval process for marketing of new medical devices and pharmaceuticals.
- While noting the progress that Japan has made in improving the competitive conditions and efficiency in its *financial sector*, the United States has recommended that Japan eliminate unnecessary regulatory barriers and improve transparency. The United States has also been pressing Japan to resolve the high volume of non-performing bank loans that have plagued the Japanese financial system for more than a decade.
- In *competition policy*, the United States encouraged Japan to increase the authority and resources of the Japan Fair Trade Commission (JFTC) to clamp down on anticompetitive practices that violate Japan's Antimonopoly Act (AMA), its primary antitrust statute. Japan has done so. The United States has recommended that the government should stiffen penalties for violations of the AMA through higher fines and prison terms. The United States also wants Japan to further restrict bid-rigging on government procurement contracts.
- In the area of *commercial law*, the United States has recommended, among other things, that Japan adopt modern merger techniques to accelerate economic restructuring, to increase shareholder participation through proxy voting, to

protect whistleblowers, and to promote alternative dispute resolution mechanisms within the business community to make dispute resolution more efficient.

- Regarding *goods distribution*, the United States wants Japan to improve the efficiency of cargo handling and customs clearance at airports. The United States encourages Japan to remove barriers that might inhibit the development of express carrier industry.

Japan's Concerns

Japan's concerns regarding the U.S. regulatory environment span many sectors of the U.S. economy:

- Japan has cited some *customs regulations and practices* the United States has implemented since September 11, 2001, as unnecessarily hindering the movement of people and goods. In particular, Japan has cited visa restrictions and requirements that have burdened Japanese residents in the United States and those arriving in the United States on business or pleasure. Japan has encouraged the United States to make sure that regulations imposed to stop terrorism still meet international standards and do not unnecessarily hinder commerce.
- Japan has long complained about U.S. government protection of the domestic *maritime industry.* In particular, Japan wants the United States to remove subsidies for the industry, to eliminate cargo preference measures that discriminate against foreign carriers in shipping between U.S. ports, including the export of Alaskan oil.
- Japan has been challenging U.S. *antidumping* measures. (This issue is discussed later in the "Issues and Disputes in the WTO"section.)
- Japan has asserted that U.S. government review of *foreign direct investments* in the United States for national security reasons creates unpredictable conditions for Japanese investors. The Japanese government notes that the definition of "national security" under the governing statute, the Exon-Florio provision (section 751 of the Defense Production Act of 1950), is ambiguous, making it difficult for foreign investors to conduct business in the United States.
- In the area of *intellectual property rights*, Japanese officials have recommended that the United States change regulations for granting patents. For example, Japan claims that the United States should adopt a "first-to-file" principle when determining conflicting patent claims rather than the "first-to-invent" principle it now uses, the only country to do so, Japan asserts. Japan argues that it is much more difficult to determine patent rights under the "first-to-invent" procedure.
- Japan raises the issue of U.S. *economic sanctions for foreign policy objectives*, that are applied to enterprises of third countries. In particular, Japan has cited the sanctions imposed under the Iran and Libya Sanctions Act of 1996, the Cuban Liberty and Democratic Solidarity Act of 1996, and the Burmese Freedom and Democracy Act of 2003, claiming these sanctions are not legitimate under international law and should be removed.

Issues and Disputes in the WTO

Both the United States and Japan have pursued complaints against one another in the WTO, either as a sole complainant or with other members. Japan has targeted primarily U.S. trade remedy laws and the United States has targeted primarily Japanese sanitary and phytosanitary (SPS) regulations. Two outstanding cases relate to Japan's complaints against the United States for failure to comply with WTO decisions in trade remedy cases.

Byrd Amendment

Japan, together with other major trading partners, has challenged U.S. trade laws and actions in the World Trade Organization (WTO). For example, Japan and others challenged the U.S. 1916 Antidumping Law and the so-called Byrd Amendment (which allows revenues from countervailing duty and antidumping orders to be distributed to those who had been injured). In both cases, the WTO ruled in Japan's favor. Legislation to repeal the 1916 law was passed by the 108th Congress. In November 2004, the WTO authorized Japan and the other countries to impose sanctions against the United States. In September 2005, Japan imposed 15% tariffs on selected imports of U.S. steel products as retaliation, joining the EU and Canada. It is the first time that Japan has imposed punitive tariffs on U.S. products. In the meantime, a repeal of the Byrd Amendment was included in the conference report for S. 1932, the Deficit Reduction Act of 2005, that received final congressional action on action February 1, 2006, and was signed by the President into law (P.L. 109-171) on February 8, 2006. The measure phases out the program over a period ending October 1, 2007.[20] Although Japan has praised the repeal of the Byrd Amendment, it has criticized the delayed termination of the program. Japan announced in August 2006 that it would maintain the tariff sanctions until October 1, 2007. In August 2007, Japan notified the WTO that it would extend the sanctions for another year and did so on September 1, 2009. The sanctions are in the form of a 9.6% additional duty on imports of U.S. ball bearings and tapered roller bearings.

Zeroing

On January 10, 2008, Japan requested permission from the WTO to impose sanctions on U.S. imports valued at around $250 million in retaliation for the failure of the United States to comply with a WTO Appellate Body decision against the U.S. practice of "zeroing" in antidumping duty determinations. The practice is one under which the U.S. Department of Commerce treats prices of targeted imports that are above fair market value as zero dumping margin rather than a negative margin. It results in higher overall dumping margins and U.S. trading partners have claimed and the WTO has ruled that the practice violates WTO rules. On April 24, 2009, a WTO compliance panel ruled that the United States had failed to comply with the original dispute panel ruling. On May 20, 2009, the United States appealed the ruling, and on August 18, 2009, the WTO Appellate Body reaffirmed the compliance panel ruling and the report was adopted by the Dispute Settlement Body on August 31, 2009. Japan had held off taking its case to the next level by asking for the right to impose up to $250 million in retaliatory measures on the United States

[20] For more information on the Byrd Amendment, see CRS Report RL33045, *The Continued Dumping and Subsidy Offset Act ("Byrd Amendment")*, by Jeanne J. Grimmett and Vivian C. Jones.

for its non-compliance, but reportedly may be preparing to do so, along with the EU, which won a similar decision from the WTO.[21]

Doha

More broadly, Japan and the United States are major supporters of the Doha Development Agenda (DDA), the latest round of negotiations in the WTO. Yet, the two have taken divergent positions in some critical areas of the agenda. For example, the United States, Australia, and other major agricultural exporting countries have pressed for the reduction or removal of barriers to agricultural imports and subsidies of agricultural production, a position strongly opposed by Japan. At the same time, Japan and others have argued that national antidumping laws and actions that member countries have taken should be examined during the DDA, with the possibility of changing them, a position that the United States has opposed.

Prospects and Policy Options

The U.S.-Japan economic relationship is very strong and mutually important. The two economies are highly integrated via trade in goods and services. More importantly, Japan and the United States are connected via capital flows. Japan is the largest foreign source of financing of the U.S. national debt and is expected to remain so for the foreseeable future, as the mounting U.S. debt needs to be financed and the stock of U.S. domestic savings remains insufficient to meet the demand. Japan is also a significant source of foreign private portfolio and direct investment in the United States, and the United States is the origin of much of the stock of foreign investment in Japan.

The *relative* significance of Japan and the United States as each other's economic partner has diminished somewhat with the rise of China as an economic power, and with deepening U.S. economic ties with Canada and Mexico as a result of the North American Free Trade Agreement (NAFTA). Nevertheless, analyses of trade and other economic data suggest that policy leaders of both countries face the challenge of successfully managing a critical economic relationship.

During the last decade, policy leaders seem to have made a deliberate effort to drastically reduce the friction that prevailed in the economic relationship. On the one hand, this calmer environment has stabilized the bilateral relationship and permitted the two countries to focus their attention on other issues of mutual interest, such as national security. On the other hand, as some have argued, the friendlier environment masks serious problems that require more attention, such as continuing Japanese failure to resolve long-standing market access barriers to U.S. exports of autos and flat glass, and the continuing presence of bilateral trade imbalances. Failure to resolve any of these outstanding issues could cause friction to heighten between the two countries.

As Japan and the United States continue to manage their economic relationship they have at least three options on how to proceed. These are not necessarily mutually exclusive options but could be employed more or less in tandem.

[21] *International Trade Reporter.* February 11, 2010.

Reliance on the WTO

One option would be to rely increasingly on the WTO dispute settlement mechanism to resolve bilateral issues by taking more lingering issues to the WTO for resolution.[22] This option could help to promote stability in the bilateral relationship by containing political friction like that which erupted in the 1980s and 1990s. In addition, it could lessen the perception that many Japanese have had that the United States was acting unilaterally in making its demands on Japan to open up its markets and in threatening to limit market access to Japanese exporters in retaliation. The WTO could provide at the least the semblance of neutrality where both countries could anticipate fair treatment by their peers.

A potentially major constraint on the use of this option is the limited scope of the WTO's coverage. A number of long-standing issues in U.S.-Japan economic ties pertain to competition policy, that is, how governments use their authority to ensure fair competition among producers. Although the WTO membership is in the midst of the Doha Development Agenda (DDA) round of negotiations to broaden the WTO rules, they have removed competition policy from the agenda. However, the WTO could be used to resolve issues that come under its purview, which may grow as negotiations in the Doha Development Agenda round progress.

Special Frameworks

A second option would be to discuss economic ties through a special framework and/or sector-specific agreements. These frameworks allow each country to raise issues that are not subject to international rules but nevertheless cause problems in the relationship. In addition, they provide a forum for officials to address issues before they emerge as full-fledged disputes. However, the record with respect to special frameworks, such as the Market-Oriented Sector-Selective (MOSS) talks and the Structural Impediments Initiative (SII), is mixed. While the United States and Japan have achieved some successes, a number of issues seem to have lingered over the years, reappearing in successive frameworks. Similarly, the record of sector-specific agreements, such as flat-glass and autos and auto parts, reflects only partial success.

FTA

A third option would be for the United States and Japan to form a comprehensive bilateral free trade agreement (FTA). This option might prove attractive because tariffs and other customs restrictions on U.S.-Japan bilateral trade are already low or non-existent, providing a foundation on which to build an FTA. In addition, proponents would argue that the two countries could construct the FTA to cover policies and practices that are critical to the relationship. For example, the FTAs that the United States has concluded recently go beyond trade in goods and address services, foreign investment, and intellectual property rights. A U.S.-Japan FTA would fit into current Japanese and U.S. trade strategies to use FTAs to strengthen economic ties with Asian partners.

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[22] See, for example, C. Fred Bergsten, Takatoshi Ito, and Marcus Noland, No More Bashing: Building a New Japan-United States Economic Relationship (Washington, D.C.: Institute for International Economics, 2001), arguing that the WTO should play a more important role in U.S. trade policy management with Japan and that "bashing" of Japan no longer has a role.

Critics of the FTA option have pointed out U.S. agricultural producers (and WTO rules) would require that Japan allow free trade to include access to its agricultural markets—a step that it has been very reluctant to take. Critics have also asserted that an FTA between two economic powers such as Japan and the United States could dramatically undermine multilateral efforts in the WTO.

Appendix. Managing the U.S.-Japan Economic Relationship—A Brief History

For the United States and Japan, managing their economic relationship has meant cooperating in areas of mutual agreement and addressing problems in a manner that meets the national interest of each country while maintaining the integrity of the alliance. While the two countries have succeeded in doing this, by and large, trade frictions became heated at times, making relations difficult.

The United States dominated the economic relationship with Japan for many years after World War II. The United States was by far the largest economy in the world, and Japan was dependent on the United States for national security. The United States set the agenda, and the issues on the agenda were driven by the U.S. demands for Japan to curb exports to the United States and/or to remove barriers to U.S. exports and investments.

Until recently the United States and Japan, largely at the instigation of the United States, had used special bilateral frameworks and agreements to conduct their government-to-government economic relations. Some of these mechanisms were designed to address trade and investment barriers in Japan that were product-specific, for example semiconductors and autos, and others were designed "generic" barriers that affected many sectors, such as the Japanese retail distribution system.

The Reagan Administration introduced the first multi-sector negotiating framework—the Market-Oriented Sector-Specific (MOSS) talks—with Japan in March 1985. The process resulted from discussions between President Reagan and Prime Minister Nakasone to find a way to deal with trade issues that had been clouding the relationship for some time. The initial set of negotiations covered four sectors: telecommunications, medical equipment and pharmaceuticals, forestry products, and electronics. The two countries added auto parts later. The sectors were selected because of the potential for U.S. companies to increase exports to the Japanese markets if the barriers were removed. They were also sectors in which multiple Japanese government barriers to imports existed. The United States and Japan reached agreement in all of the MOSS sectors. A 1988 General Accounting Office (GAO) study concluded that U.S. exports in each of the selected sectors except auto parts increased but that improved market access does not necessarily guarantee huge increases in exports.[23] Macroeconomic trends and other factors also play a role that could trump market access.

In March 1989, President George H.W. Bush with Prime Minister Uno launched the Structural Impediments Initiative (SII) that targeted a broad range of Japanese macroeconomic policies and practices and structural factors that underlay the persistent U.S.-Japan trade imbalances and the inability of U.S. exporters and investors to penetrate or increase their presence the Japanese market. The SII was a pioneering effort in that U.S. negotiators targeted Japanese barriers that were cited by not only American exporters and investors, but also by Japanese academics, business leaders, and politicians. In so doing, the U.S. side sought to increase the possibility of a successful outcome if it had a domestic constituency in Japan that would be working to achieve

[23] U.S. General Accounting Office, *U.S.-Japan Trade: Evaluation of the Market-Oriented Sector-Selective Talks,* GAO/NSIAD-880205, July 1988. p. 57.

the same goal. In addition, the targeted policies and practices were ones that were fundamental to Japanese economic life and had not been subject to bilateral negotiation. These targets were Japan's high savings-low investment imbalance that many economists attribute its perennial current account surpluses; the Japanese retail distribution system, particularly its Large-Retail Store Law that favored small "mom and pop" enterprises at the expense of larger operations, such as Toys R Us; land use policies that inhibited the market entry of new firms and kept land prices high; the *keiretsu* business conglomerates that both Japanese and U.S. experts blamed as a barrier to the entry of new Japanese and foreign firms to the Japanese market; exclusionary business practices, such as the formation of cartels to limit competition; and business pricing practices under which Japanese companies would sell products at a premium in Japan so that they could undersell their competitors in the U.S. market.

The SII also included U.S. policies and practices, such as the low U.S. savings rate, that Japanese negotiators asserted was a cause of U.S. trade deficits. This element was an attempt to make the format more balanced. However, it was generally understood that the real focus of the SII was Japanese barriers. The SII process operated throughout the four years of the George H.W. Bush Administration. U.S. and Japanese negotiators met periodically and reported annually on progress made in resolving the offensive policies and practices. The results of the SII process are mixed. On the one hand, it focused attention of policymakers of both sides on fundamental causes of problems that cut across many sectors and economic activities. The SII is also credited with placing enough pressure on Japan to change its Large-Retail Store Law. Some observers also argued that by selecting policies and practices that many Japanese themselves wanted changed, the United States lessened the unilateral thrust of previous negotiations. On the other hand, many of the problems that had plagued the U.S.-Japan relationship before the SII remain, such as the trade imbalances.

The Clinton Administration negotiated is own bilateral framework with Japan. The "United States-Japan Framework for a New Economic Partnership" borrowed elements from the MOSS and the SII processes by including some sector-specific goals along with overall structural and macroeconomic issues. These goals were included in five "baskets." This framework departed from the others in several important ways. It obligated the President and the Prime Minister to meet at least twice a year to review progress under framework. At the insistence of the Clinton Administration, "objective criteria" were to used to determine whether Japan was fulfilling its obligations under the framework. This element proved highly controversial, and the two countries never agreed on the role the "objective criteria" would play or, for that matter, what they would be. The United States argued the criteria were to be targets Japan was to meet while Japan did not want to be bound by such criteria and argued that the criteria were to be guidelines. The differences over "objective criteria" reached the summit level and strained U.S.-Japan relations.

The United States and Japan reached agreements in most of the areas, including medical equipment procurement, intellectual property rights protection, financial services, insurance, and flat glass, among others, but not without some acrimony. For example, the United States was on the brink of imposing tariff-sanctions on Japan, and both countries were poised to take one another to the WTO before they reached agreement on Japanese imports of autos and auto parts. U.S.-Japanese trade friction reached its peak during the period of that Framework that roughly corresponds to the first Clinton Administration. The friction was due in part to the long-running frustration that U.S. exporters and investors were experiencing with the same obstacles that previous agreements were supposed to have addressed. The "results-oriented" strategy was intended to provide a clear indicator of whether Japan had removed the barriers. But Japan resisted such objective indicators, because, it argued, the problems in U.S.-Japan trade stemmed from private sector practices and not government policies. The Framework raised the issues to the summit level to ensure that both sides took the issues seriously. By doing so, however, the Framework increased the risk that failure to achieve results would sour the entire relationship.

With the completion of the auto and auto parts agreement in 1995, most trade issues in the Framework had been completed. The Clinton Administration closed the books on the Framework. In its place, it got Japan to agree in June 1997 to another, more loosely shaped format, the Enhanced Initiative on Deregulation and Competition Policy (the Enhanced Initiative). This format did not have the results-oriented elements of the previous Framework. It was a mechanism for exchanging views on some of the fundamental aspects of the Japanese economy that limited competition and were likely preventing Japan from emerging from the economic malaise that had set in. These issues had not received as much attention in previous negotiations. The United States focused on getting Japan to change regulations and competition policies affecting telecommunications, medical devices and pharmaceuticals, and financial services, as well as more generic issues such as competition policy and regulation transparency.[24]

The Enhanced Initiative marked a turning point in the overall U.S.-Japan relationship as economic relations became less prominent. While negotiators continued to meet to exchange views and monitor progress under the Initiative and previous agreements, the issues did not have the importance at the summit level they once had. National security issues had become more dominant in the bilateral relationship.

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[24] Edward J. Lincoln, Troubled Times: U.S.-Japan Trade Relations in the 1990s (Washington, D.C., Brookings Institution Press, 1999), pp. 158-166.