EconoMIX: Who will win the trade war?

Vol. 6: Reflecting on recent trade friction

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[Hajime Kitano's question for Yuichiro Nagai]

The Structural Impediments Initiative was a series of five meetings between Japanese and American officials in 1989 and 1990 with the aim of correcting the trade imbalance between the two countries. When the US deficit with Japan failed to decline even with the yen appreciation from the 1985 Plaza Accord, American officials concluded that the problem was due to the closed nature of the Japanese market, rather than the exchange rate, and the initiative was a way to force structural change on Japan and open its markets. The Structural Impediments Initiative was renamed the US-Framework Talks in 1993 and led to the issuance of the Annual Reform Demands from 1994.

The idea of the Structural Impediments Initiative came out of the Japan-US summit meeting of July 1989. Japan was at the height of its bubble economy at the time, with Mitsubishi Estate buying the Rockefeller Center in October 1989 for around ¥220b—a symbolic event for how money was gushing out of Japan to buy overseas assets. BIS regulations were hammered out in July 1988, prompted in part by the sense of crisis in the US and Europe that Japan's low cost of capital was the wellspring for 'Japan money'. After the bubble inevitably collapsed, a lack of willingness to tackle structural reforms presumably contributed to the subsequent period of prolonged stagnation.

The Nikkei featured 519 articles about US-China trade friction from 1 January 2018 through to 30 September, none of which mentioned the Japan-US Structural Impediments Initiative. The perception is that this initiative is completely irrelevant to the trade strife between the US and China. However, China may view Japan's experience as an object lesson if it concludes there is some form of cause-and-effect relationship between the Japan-US Structural Impediments Initiative and Japan's subsequent long-term slump.

I want to ask about this Structural Impediments Initiative. What impact did the Japan-US dialogue that started with this initiative have on the Japanese economy? For example, when you analyze the Japanese economy, to what extent do you take into account the Japan-US dialogue from the Structural Impediments Initiative?

[Mr. Nagai's response to Mr. Kitano's question]

The Japan-US dialogue that started with the Structural Impediments Initiative strongly influenced the Japanese economy thereafter. The history of Japan-US trade friction can be traced back to the early 1960s, with the friction taking two forms. First was the trade friction related to the rapid increase of products exported from Japan to the US, such as textiles, color TVs, steel, autos, and machine tools. Second was the trade friction related to the sluggish growth of products exported from the US to Japan, most notably beef, oranges, semiconductors, construction services, government procurement, rice, and supercomputers. The US blamed the second type of trade friction on the closed-nature of Japanese markets and sought to pry them open with reforms to the structure of Japan's economy. To do this, bilateral discussions were established, one of which was the Structural Impediments Initiative. Unlike earlier dialogue forums like the Japan-US Yen-Dollar Committee, the Structural Impediments Initiative stands out for extending to Japanese business practices and distribution structure. It led to two important policies: 1) coordination of exchange rate and interest rate policies; and 2) the increase of large domestic public works investment in Japan[1].

It is not possible to analyze today's Japanese economy without considering the impact of the formation and collapse of the bubble and enormous fiscal deficits. The two policies that originated in the Structural Impediments Initiative noted above are intimately related to these phenomena. The policy coordination severely restricted Japan's fiscal and monetary policies, which when combined with the sudden financial liberalization of the time and the delay in BoJ tightening, is frequently cited as a cause of the rise and fall of the bubble. The increase in public works investment of the Structural Impediments Initiative is also singled out as a remote cause of the fiscal deficit.

In fact, Japan's fiscal and monetary policies have long been repeatedly swinging from success to failure. We cannot pin all the blame for the bubble's expansion and collapse and for the fiscal deficits on the Structural Impediments Initiative in light of such macroeconomic shocks as the Japanese financial crisis, the Asian currency crisis, the GFC, and devastating natural disasters as well as the responses to these. Nonetheless, it is a deeply rooted view that there is a cause-and-effect relationship between the bubble and international policy coordination, including the impact of subsequent BIS regulations on Japanese financial institutions.

China had intensely researched Japan-US trade friction prior to the recent escalation of trade issues between it and the US. Chinese policymakers appear to view the Plaza Accord as responsible for causing Japan's bubble and subsequent downturn and they are considered reluctant to substantially adjust the exchange rate as a result. Given the major changes to the environment for the Chinese yuan, this view is not necessarily correct now, but it is still highly likely that China has looked at Japan's experience as an object lesson, including the Japan-US Structural Impediments Initiative.

Amid this situation, Prime Minister Shinzo Abe and President Donald Trump agreed at their summit meeting on 26 September (the 27th JST) to start negotiations toward

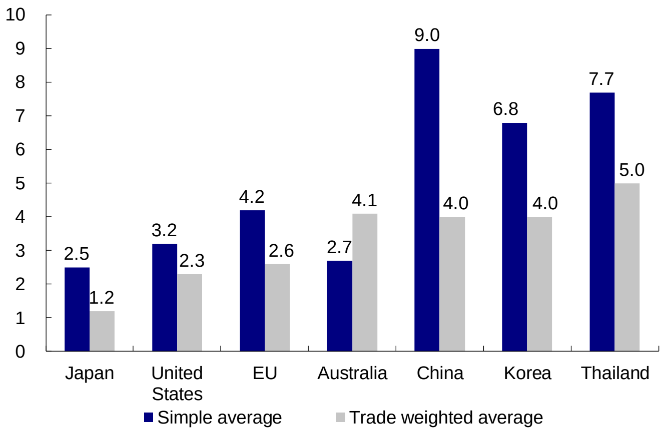
[1] The coordination of exchange rate and interest rate policies took a variety of forms, including the Plaza Accord.

concluding a Trade Agreement on Goods (TAG) to liberalize merchandise trade between the two countries. The summit statement included a pledge not to engage in action that contravenes the spirit of the joint statement during the negotiations, implying that the US will not impose the 25% tariff on imported autos that it is considering while the negotiations are under way. The Japanese side, thus, appears to have stood up well to the American hardline. The outlook, though, remains uncertain, with some suggesting that the TAG will evolve into a de facto Japan-US FTA. I began my response by dividing Japan-US trade friction into two categories. Below, I will review the outlook for both as it stands now.

(1) Negotiations on products for which US exports to Japan have been sluggish

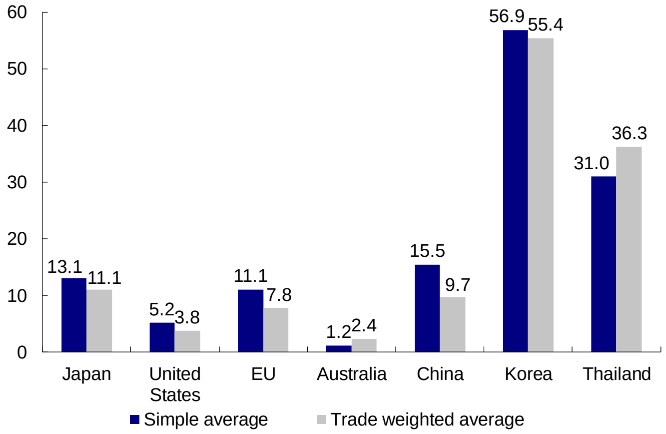
Let's start with the trade friction related to products for which US exports to Japan have been sluggish, for which the outlook at this time is comparatively straight forward. Japan's tariffs on industrial products are the lowest in the world. However, for agricultural products, they are high compared to the US and the EU, even though they are low versus the agricultural product tariffs of South Korea and some other countries (see Figures 1 and 2). This means there is still room for Japan to reduce its tariffs on imported agricultural products. The recent Japan-US summit meeting statement included a pledge for Japan to maximize market access for agricultural, forestry, and fisheries products as promised in past economic partnership agreements, evidently with a view to the Trans-Pacific Partnership (TPP), which respects the Japanese government's position on agricultural products. Consequently, there is a high probability that, in principle, the lowering of tariffs in the agricultural field will be in line with what was agreed to with the TPP (see Figure 3).

Figure 1. Tariff rates on non-agricultural products (%)



Note: The figures for China do not reflect significant rate cuts since last year.
Source: WTO "World Tariff Profiles 2017"

Figure 2. Tariff rates on agricultural products (%)



Source: WTO「World Tariff Profiles 2017」

Figure 3. Details of the TPP agreement and the government's measures (on important five items)

Items		TPP agreement details	TPP measures by product (preparations for business stability and stable supply)
Rice		The state trading system, under which national institutions and companies with rights granted by the national government have a near monopoly, is maintained, with the secondary tariff kept at ¥341/kg. A bidding system with quotas for individual countries will be used; for processed items (private-sector trade items), the tariff for rice flour and other items with a certain import volume will be reduced by 5%-25%, while the tariff for items with low import volume or a low tariff rate will be reduced or eliminated.	Management of the government stockpile of rice will be revised to ensure supply of fresh stockpiles to consumers and to prevent increased imports from country quotas from influencing the supply-demand balance and prices (in principle, the storage period will be reduced from five to three years). The government will buy domestic rice for storage equivalent to the imported volume from country quotas.
Meat	Beef	The tariff will be lowered from 38.5% to 27.5% when the agreement takes effect. It will then drop to 20% in the tenth year and 9% in the sixteenth year. Although the tariff can be raised as a safeguard in the event of a spike in imports, this measure will be abandoned if not used for four years from the sixteenth year.	Special measures for stable beef and pork fattening operations will be codified into law. The compensation rate will be raised from 80% to 90% for beef and pork fattening, while the state liability for pork fattening will be increased from 1:1 for state/producer to 1:3.
	Pork	In cases where imports are cheaper than domestic pork, the price gap tariff system will be maintained to charge a tariff equivalent to the difference with the standard price determined using the distribution price of domestic pork. The Ad valorem duty determined in line with the price will reduced from 4.3% to an initial 2.2% and then to zero from the tenth year. A safeguard will also be put in place.	
Dairy products (cheese)		Tariffs on cheddar, gouda, and crème cheese will be removed over sixteen years. An import quota system by country will be set up for proceeded cheese with low volume, while a tax-free quota will be set for fresh cheese used as a raw material for shredded cheese, with domestic product use conditions. Current tariffs will be maintained for mozzarella, camembert, and other types.	Raw crème and other liquid dairy products will be added to coverage of the processed raw material diary producers subsidy system and the subsidy unit unified, with the unit revised appropriately based on changes to the economic situation.
C starch		The current sugar price adjustment system will be maintained for raw and refined sugar, but adjustment amounts reduced modestly by eliminating the tariff on raw sugar used for high sugar content refining. Limited to test imports for new product development, imports without tariffs and adjustment fees will be allowed using the existing quotas. TPP quotas will be set for sweetened products on a per-item basis. TPP quotas for starch will be set within the scope of the current tariff allocated volumes, with country quotas set for items for which current import volumes from TPP members are low.	Sweetened products will be newly covered by adjustment amounts under the Sugar Price Adjustment Law with the aim of a stable supply of domestically produced sweetening raw materials.
Wheat and barley		As with rice, the state trading system is maintained, with the secondary tariff kept at ¥55/kg. In exchange, the markup added when the national government imports wheat for resale to millers will be cut 45% in nine years from enactment.	Given the risk of markup reduction and accompanying price declines for domestically produced wheat, measures to ensure the income stability will continue to be steadily implemented with the aim of stable supply of domestically produced wheat.

Source: Mizuho Securities Equity Research, based on media reports

Japan's tariffs on agricultural products are not uniformly high but instead are high for some items (see Figure 4). Of these, the US is particularly interested in reducing Japan's tariff on beef. However, under the TPP mentioned earlier, Japan has agreed to lower its tariff on imported beef in stages over many years, with the rate going from the present 38.5% to 27.5% when the TPP takes effect, to 20% in the tenth year and then to 9% in the sixteenth year. We, therefore, think that even if the beef tariff is reduced in a TAG agreement with the US, the downward pressure on domestic prices in Japan will be extremely gradual and limited.

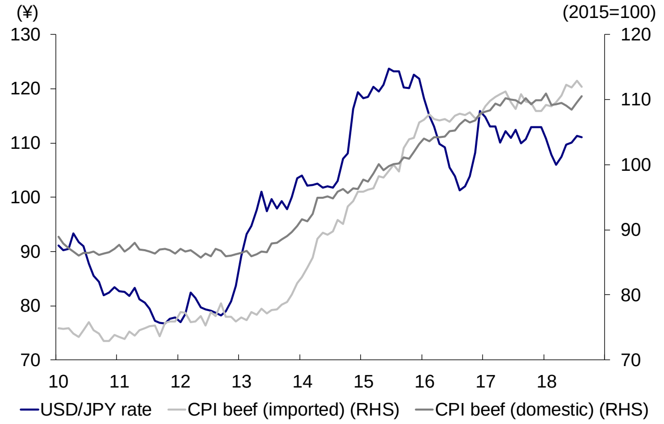
Figure 4. Japan's effective tax rates on agricultural products

Effective tax rate	No. of items	Items
0%	434	soybean, coffee bean, rapeseed, feed corn
0%-10%	421	fresh vegetables (with a few exceptions), frozen vegetables (with a few exceptions), tropical fruits (papaya, durian, etc.)
10-20%	273	green tea, fresh orange, fresh apple, chicken
20-30%	220	tomato juice, tomato ketchup, orange juice, egg
30% and over	27	beef, process cheese, rice cracker
Weight tax, etc.	166	pasta, pork, fresh onion, wine, sugar, fresh orange
Tariff quota items (incl. state trading items)	366	Rice, wheat, barley, red bean, peanut, konjac potato, corn (as raw material for cornstarch, etc.), butter, skimmed milk
Total	1907	

Source: Ministry of Agriculture, Forestry, and Fisheries

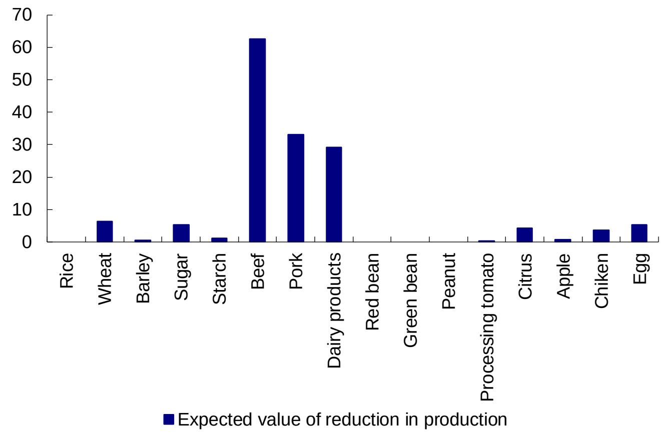
Beef prices in Japan have been rising significantly for quite a while due to the yen depreciation since the start of Abenomics (see Figure 5). In fact, the price of beef (imported products) in the August national CPI was 47.6% higher than when the Abe government took office in late 2012. Unless there is a substantial strengthening of the yen, the price of beef will not fall much with only a lowering of the import tariff. If tariffs on agricultural products, and not just beef, are lowered in line with the TPP agreement, the impact on the Japanese economy should be limited (see Figure 6).

Figure 5. CPI for beef and USD/JPY FX rate



Source: Ministry of Internal Affairs and Communications, Bank of Japan

Figure 6. Government's estimate on impact on agricultural production (¥b)



Source: Cabinet Secretariat

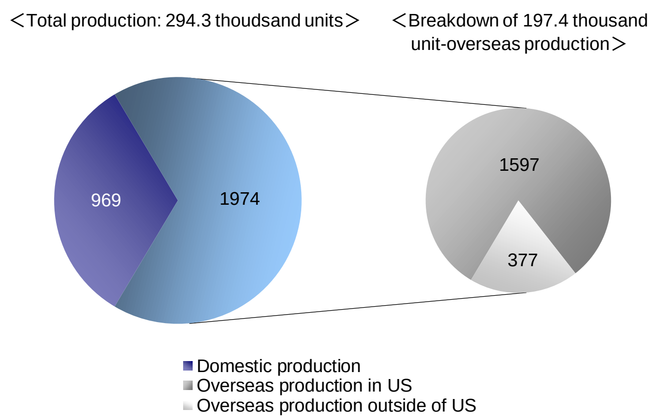
(2) Negotiations on products for which exports from Japan to US have risen sharply

On the other hand, the outlook for the trade friction caused by Japanese exports to the US is unclear, especially for autos. This type of trade friction should actually have been resolved by now as a result of the efforts of Japanese companies over more than 30 years to transfer production to the US. Despite this, the US has taken a hardline, threatening in recent negotiations to impose a 25% tariff on Japan's auto exports, and this has clouded the outlook.

In addition, the latest summit statement, as discussed above, includes text that implies respect for the Japanese government's position on agricultural products but it also respects the stance of the US government by stating that "market access outcomes in the motor vehicle sector will be designed to increase production and jobs in the United States in the motor vehicle industries."

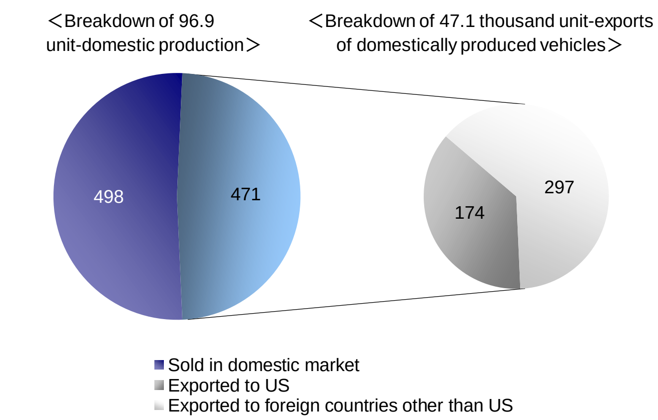
As of 2017, Japanese automakers were already manufacturing 3.77m vehicles in the US, accounting for 13% of their global production of 29.43m vehicles (see Figure 7). The summit statement suggests that Japanese automakers will be pressured to further increase their contribution to production and employment in the US. Japan exported 1.74m vehicles to the US in 2017, which was equivalent to 6% of their global production of 29.43m vehicles and 18% of their domestic production of 9.69m vehicles (see Figure 8). If Japanese automakers have room to expand production and employment in the US to a level that would satisfy the US, it could mean investment in the US in line with this agreement. If not, auto exports from Japan to the US would have to be reduced, in what would amount in practical terms to the introduction of an import quota. Japanese automakers may find they have no other option but to raise output at their US operations.

Figure 7. Japanese auto makers' production by site (2017)



Source: Japan Automobile Manufacturers Association

Figure 8. Destination of Japanese auto makers' domestic production (2017)



Source: Japan Automobile Manufacturers Association

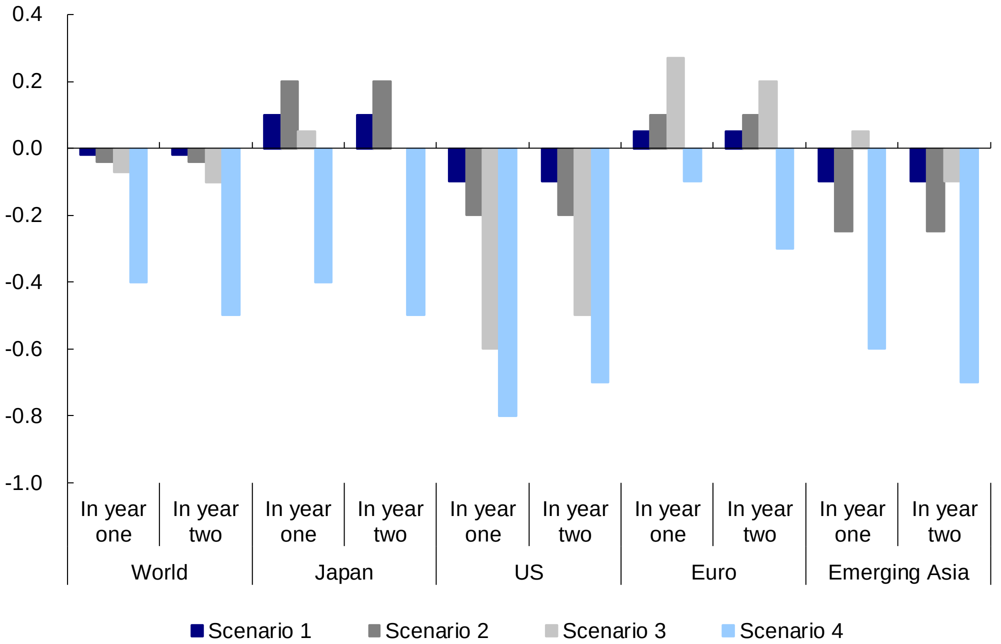
(3) Even with an agreement between the US and Japan, US-China trade issues will take time to resolve

Even if Japan-US trade friction, including the auto issue, is resolved as expected (without leading to the imposition of an import quota), it would not dispel concern over the impact of US-China trade friction. In July, the IMF estimated that US-China trade friction would depress global GDP by around 0.5% by 2020 on the assumption that, in addition to measures already taken in the form a 25% tariff on steel, a 10% tariff on aluminum, and a 25% tariff on $50b worth of imports from China, the US imposes a 10% tariff on another $200b of imports from China and investor sentiment worsens in response to these tariffs (this is case 4 in Figure 9). By country, the IMF estimates the impact on GDP by 2020 at 0.8% for the US, 0.7% for China and emerging markets in Asia, and 0.6% for Japan. Fallout on this scale cannot be ignored.

Moreover, the 25 September edition of the Nikkei reported that estimates to be disclosed at the IMF's annual meeting in October will find that the trade war that America has unleashed will lower the real growth rates for the US and China by up to 0.9% in 2019. For the global economy, the estimate is for a lowering of growth by as much as 0.7%, with the impact expanding from the IMF's estimate of July. Aside from the stagnation of trade from tariff hikes, the trade war is expected to put downward pressure on the economy by raising funding costs as a result of turbulence in global financial markets and deteriorating corporate earnings.

US-China trade friction can be viewed as stemming from the hardline American negotiating stance as the Trump administration eyes the midterm elections and the next presidential election. However, considering Chinese business practices and other factors, the trade problem is not unique to the Trump administration but is probably set to be prolonged. We need to bear in mind that such a problem does not lend itself to easy resolution even if the president changes with the next election.

Figure 9. Estimating the impact of trade friction on GDP (%)



Note: Scenario1 incorporates higher tariffs on US imports of steel (25%) and aluminum (10%); scenario 2 adds to scenario1 an additional 25% tariff on US$50 billion worth of U.S. imports from China; scenario 3 adds to scenario2 an additional 10% tariff on US$200 billion worth of U.S. imports from China; scenario 4 introduces a temporary global shock to confidence on top of scenario3.
Source: International Monetary Fund (2018) "G-20 Surveillance Note"

[A reply from Mr. Kitano to Mr. Nagai]

The difficulty of trade negotiations with the US appears to reflect the close relationship with national security issues as well. National security arguments can lead to outcomes that are out of the question by the logic of economists. While a trade war touched off by the US that reduces growth in both the US and China by as much as 0.9% would seem to be in nobody's interest, there is a risk that the US is adopting a strategy of losing the battle to win the war, and that's frightening.

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