



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. Failure to resolve any of these outstanding issues could cause heightened friction between the two countries.

For the time being the U.S.-Japan economic relationship will likely be dominated by the effects of the March 11, 2011, earthquake and subsequent tsunami and nuclear plant accident in northern Japan. The ramifications of those effects are still unfolding, and the ultimate economic impact is still to be determined. At a minimum the damage to production facilities and infrastructure in the immediate vicinity of events and the resulting power outages further from the site have caused production delays elsewhere in Japan as well in the United States and other parts of the world, exposing interdependencies associated with transnational supply chains.

More generally, other issues regarding U.S.-Japan economic relations may emerge on the agenda of the 112th 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. Until the March 11, 2011, events, the Japanese leadership was considering whether to participate in negotiations on the Trans-Pacific Partnership (TPP) 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 among the world's largest economic powers. Together they account for over 30% of world domestic product (2010 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 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 added another dimension to the relationship as the two countries have grappled with the severe impact of the crisis on their respective economies and simultaneously have worked with their partners in the G-20 to coordinate a multilateral response.

The impact of the March 11, 2011, earthquake and subsequent tsunami and nuclear plant accident in northern Japan have added still another and immediate factor to the bilateral economic relationship. Events are still unfolding, and the ultimate effects are yet to be determined. Nevertheless, the crisis could test the viability of the bilateral economic relationship.

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 Congress plays a critical role in shaping U.S. economic policy toward Japan. To assist Congress in fulfilling its responsibilities, this report explores the significance and state of U.S.-Japan economic ties; major issues in the relationship; and the possible options for managing the relationship.

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 both 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 as large as 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 two decades, while U.S. economic growth had been stronger, at least

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.

until recently. For example, the U.S. average annual GDP growth rate during the last 10 years (2001-2010) has been more than 2 times that of Japan's. Japan had been especially hit hard by the global economic downturn. In 2009, its GDP declined 6.3%, while the United States' GDP declined 2.5%. In 2010, Japan's GDP increased 4.0% and the U.S. GDP grew 2.9%. Nevertheless, the economic recovery was expected to be fragile, especially in Japan, and the impact of the March 11 earthquake will likely undermine that recovery.

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 (23.8% versus 9.6%). 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 (2010)		
-Nominal (billions of \$U.S.)	5,462	14,723
-PPP (billions of \$U.S.)	4,282	14,723
Per Capita GDP (2010)		
-Nominal	43,070	47,560
-PPP (U.S. Dollars)	33,770	47,560
Real GDP Growth Rates (2010)	4.0%	2.9%
Average Annual Real GDP Growth Rate (2001-2010)	0.7 %	1.7%
Exports as % GDP (2010)	15.2%	12.5%
Imports as % GDP (2010)	14.1%	16.2%
Current Account Balance as % of GDP (2010)	2.8%	-3.4%
Gross National Savings Rate (2010)	23.8%	9.5%
Recorded Unemployment Rates (2010)	5.1%	9.6%

Source: Economist Intelligence Unit

U.S.-Japanese Trade in Goods and Services

U.S.-Japanese bilateral trade in goods and services had grown over time, but declined significantly in 2009 because of the global economic downturn. The pace of U.S.-Japan trade picked up in 2010, as **Table 2** shows. 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, 1998-2010

(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
2010	60.5	120.3	180.8	-59.8

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 and into 2010. 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. For many years, the United States was Japan's largest export market but became the second largest since 2009 (next to China). The United States was second-largest source of imports as of the end of 2010.

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 nine of the largest economies in East Asia.² In 2010, 53.4% of Japanese exports and 42.5% of Japanese imports were with the nine countries of East Asia. China is the fastest-growing Japanese trade partner.

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

Similarly, the geographic pattern of U.S. trade has shifted. Mexico and 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 2010.³ (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, 2001-2010

(\$ in billions)

Year	U.S. Exports	U.S. Imports	Trade Turnover	U.S. Balances
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	42.3	25.7	68.0	16.6
2009	41.4	22.9	64.3	18.5
2010	46.6	26.6	73.2	20.0

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, 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

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.

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, 1998-2009

Historical-Cost Basis
(\$ in billions)

	Japanese FDI in U.S.	U.S. FDI in Japan
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	204.0	84.4
2007	229.4	85.2
2008	259.8	101.9
2009	264.2	103.6

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 1998 to 2009, U.S. FDI in Japan has more than doubled. 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. 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, 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 billion by 2002. The level of Japan’s FDI in the United States has increased since, reaching \$264.2 billion in 2009 (latest available data). 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 at the end of 2009.⁴

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 2009, U.S. investors held \$373.2 billion in Japanese corporate stocks and \$38.7 billion in Japanese bonds. Japanese investors held \$222.8 billion in U.S. corporate stocks and \$276.7 billion in U.S. corporate bonds.⁵

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 2010, Japanese residents held \$882.3 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, investors in China surpassed them and, as of the end of 2010, held \$1,160.1 billion in U.S. Treasury securities.⁶ 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 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 third-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.

⁴ Department of Commerce, Bureau of Economic Analysis..

⁵ *Survey of Current Business*. July 2010, 12-15.

⁶ U.S. Department of the Treasury, <http://www.ustreas.gov/tic/>.

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.⁷

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 2010, the U.S. trade deficit with Japan was \$59.8 billion; the deficit with China was \$273.1 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. The United States has FTAs with Jordan (2001), Chile (2004), Singapore (2004), Australia (2005), Morocco (2006), Bahrain (2006), the Dominican Republic and Central America (DR-CAFTA, 2007), Oman (2009), and Peru (2009). Other agreements have either been completed or are still under negotiation.

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.⁸ 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

⁷ For example, Clyde V. Prestowitz, *Trading Places: How We Allowed Japan to Take the Lead* (New York: Basic Books, 1988).

⁸ For more information on Japan's FTAs, see CRS Report RL33044, *Japan's Free Trade Agreement Program*, by Raymond J. Ahearn.

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.

The Earthquake, Tsunami, and Nuclear Accident in Northeastern Japan

The effects of the March 11 earthquake and related events in Japan are likely to dominate the U.S.-Japan economic relationship, at least for the foreseeable future. These events are still unfolding; therefore, any economic impact assessments are at best preliminary. The effects could be profound in the near term and on specific sectors and firms for which trade and investment with Japan is particularly important.

The earthquake crisis is expected to diminish economic growth in Japan in the near term; therefore, U.S. exports could decline, depending on the extent of the impact. One forecast estimates that the Japanese economy will experience a recession in 2011 with a decline in GDP of 1%-3% as a result of the crisis.⁹ Others estimate the crisis will diminish the rate of GDP growth by 0.3% to 0.5% GDP.¹⁰ Most forecasts indicate that Japan's GDP will increase as the country begins reconstruction.

Some sectors of U.S.-Japan trade are likely to be directly affected. For example, close to 35% of U.S. imports from Japan in 2010 consisted of passenger cars and auto parts. Some Japanese auto manufacturers, such as Toyota Motor Corp., have assembly operations in the immediate vicinity of the earthquake. Other manufacturers who may not be directly located in the earthquake area have been affected by power outages and other effects of the disaster and have had to curtail operations, reducing output. Japanese auto manufacturers have also been adversely affected by disruption of operations of parts suppliers.¹¹

In addition, U.S.-based auto manufacturers may also be affected by the problems in Japan. Some Japanese-owned companies in the United States have had to curtail operations because they cannot obtain parts from Japan. For example, some models assembled in the United States by Toyota, Mitsubishi, Nissan, and Mazda import engines and/or transmissions from Japan.¹² Also, some U.S.-name plate manufacturers have been affected. Ford Motor Co. depends on imports of Japanese-made memory chips and batteries. In addition, a significant portion of U.S. imports from Japan are in machinery (20.6%), including printers and computers, and electrical machinery (15.2%), including semiconductors, shipments of which could be interrupted because of the crisis. The full extent of the effects of the problems in Japan is yet to be determined.¹³

⁹ Morgan Stanley Research, *The Global Monetary Analyst*, March 23, 2011.

¹⁰ Global Insight, *Japan's March 2011 Earthquake: Disruption, Risks and Outlook*, March 16, 2011. Standard Chartered Research, *Japan—Assessing the Impact*, March 15, 2011.

¹¹ *Automotive News*, March 14, 2011.

¹² National Highway Administration, <http://www.nhtsa.gov>.

¹³ *Automotive News*, March 15, 2011. On March 17, 2011, General Motors reported that it had to close down a plant in Shreveport, Louisiana because of an interruption parts shipments from Japan. *The New York Times*, March 18, 2011, p. B1.

Trade in services could also be affected. Hawaii already has experienced cancellations of tours from Japan. Japanese tourists accounted for \$1.9 billion in revenue in Hawaii, 18% of tourist arrivals there, and numbered second only to arrivals from other parts of the United States.¹⁴ For the United States as a whole, about 3.5 million tourists from Japan arrived in 2010, placing Japan in fourth place after Canada, Mexico, and the United Kingdom.¹⁵

Another factor that affects trade flows is exchange rates. Over the past year, the Japanese yen has attained historically high values in terms of the dollar and other currencies as investors sought a safe haven during the financial crisis. Less than four years ago the yen was valued at \$1=¥122. On March 17, 2011, the value was \$1=¥78.8, which was the highest value since the end of World War II. It has depreciated slightly since then. On March 28, it was \$1=¥81.7. Recent yen appreciation may be caused in part by speculation that Japan will need to repatriate funds from abroad to finance the reconstruction. The higher yen in terms of the dollar makes Japanese exports more expensive and U.S. exports less expensive.¹⁶

Issues and Prospects

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. 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

¹⁴ “Japan crisis ‘terrible’ for Hawaii tourism,” *UPI.com*, March 17, 2011.

¹⁵ U.S. Department of Commerce, International Trade Administration, *Table C - Section 5: United Kingdom, Japan, S. Korea, PRC (EXCL Hong Kong), ROC(Taiwan) Non-Resident Visitation to the U.S. By world region/country of residence 2010*, 2010 Monthly Tourism Statistics, Washington, DC, Data through November 2010, <http://tinet.ita.doc.gov/view/m-2010-I-001/table5.html>.

¹⁶ The Group of 7 countries (United States, Canada, Japan, Germany, Italy, France, and the United Kingdom) have decided to intervene the currency markets to stabilize the yen. *The New York Times*, March 18, 2011, p. B1.

May 27, 2009, the Japan Ministry of Health, Labor, and Welfare and the Ministry of Agriculture, Forestry, and Fisheries reportedly was 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.¹⁷ In a meeting with 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.¹⁸ U.S. officials met with Japanese agricultural officials September 14-15, 2010, for technical discussions on getting Japan to loosen its restrictions even further, but produced with no clear indication of resolution of the issue.¹⁹

Byrd Amendment

Japan, together with other major trading partners, challenged U.S. trade laws and actions in the World Trade Organization (WTO). For example, Japan and others challenged the so-called Byrd Amendment (which allows revenues from countervailing duty and antidumping orders to be distributed to those who had been injured). The WTO ruled in Japan's favor. In November 2004, the WTO authorized Japan and the other complainant-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 had 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 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 criticized the delayed termination of the program and has maintained the sanctions on imports from the United States. Consequently, 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, as it did recently in August 2010.

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

¹⁷ *International Trade Daily*. May 28, 2009.

¹⁸ *Inside U.S. Trade*. October 16, 2009.

¹⁹ *International Trade Daily*. September 17, 2010.

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

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 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.²¹ It is unclear at this point how these initiatives might affect U.S. insurance providers.

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 for its non-compliance, but reportedly may be preparing to do so, along with the EU, which won a similar decision from the WTO.²²

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

²¹ *Inside U.S. Trade*. October 30, 2009.

²² *International Trade Reporter*. February 11, 2010.

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.

Overarching Issues

For more than a decade, U.S.-Japanese bilateral economic discussions have concentrated less on the specific issues and more on fundamental factors that cut across many aspects of the U.S. and Japanese economies. Given the complexity of many of these issues, they have been the basis of discussion, negotiations, and disputes for many years. The United States and Japan have addressed these issues within various frameworks over the years. (See discussion in the **Appendix**, “Managing the U.S.-Japan Economic Relationship—A Brief History.”)

Most recently, President Obama and Prime Minister Kan agreed in November 2010 to establish the United States-Japan Economic Harmonization Initiative to discuss them. Under this initiative, the two sides are to meet several times in 2011. The first meeting was held February 28-March 4 in Tokyo. During that session the United States presented its concerns regarding the Japanese economic policies, structure and practices. These issues include:

- encouraging more competition and transparency in the communications sector;
- improving competition, efficiency, and quality in the information technologies area;
- improving the protection of intellectual property rights;
- ensuring that services of the Japan postal system, such as insurance and express delivery, are provided in a manner that does not give them an unfair competitive advantage; and
- promoting the use of innovative pharmaceuticals and medical devices through its national health care system by, among other things, reforming its policies and procedures on reimbursements for those products.²³

Japan will present its concerns at future meetings.

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.

²³ For more details of U.S. concerns, see Office of the United States Trade Representative, *United States-Japan Economic Harmonization Initiative*, February 2011, accessed at <http://www.ustr.gov>.

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. 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, and to discuss fundamental issues, such as regulatory reform and competition policy, that are the basis of many outstanding issues in the bilateral economic relationship.

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

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.²⁴ 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)

²⁴ 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.

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.

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.

Regional Agreements—TPP

The Trans-Pacific Partnership (TPP) is an evolving regional free trade agreement FTA. The TPP was originally an FTA among Singapore, New Zealand, Chile, and Brunei. The United States, along with Australia, Peru, and Vietnam, joined the negotiations in the fall of 2008 to accede to the TPP and shape arrangement, and President Obama reaffirmed U.S. participation in November 2009. Three rounds of negotiations were held in 2010, and Malaysia joined as a full partner during the third round. The Obama Administration envisions the TPP becoming a high-level, comprehensive FTA covering goods, services, agriculture, investment, intellectual property rights, government procurement, competition, labor, environmental, and disciplines on non-tariff barriers.

The Japanese leadership is contemplating joining the negotiations and has been the subject of Cabinet-level discussions. It was expected that the leadership would decide soon enough to be able to participate in the early rounds of negotiations and help establish the basic provisions of the TPP to which later adherents would have to accede. Participation in the TPP would likely require Japan to open its agricultural markets to imports from other TPP members, including the United States and Australia, an issue that has been a roadblock to joining forming some other FTAs.²⁵

The Obama Administration has engaged in discussions with Japan regarding the possibility of Japan joining negotiations to establish the Trans-Pacific Partnership (TPP) Initiative. Before the March 11 earthquake, the government of Prime Minister Kan indicated it would make a decision on TPP by this June 2011. The Kan government has since indicated that a decision on TPP would

²⁵ *Inside U.S. Trade*, November 12, 2010.

have to be delayed as it deals with the effects of the March 11 events. The Obama Administration has replied that it understands if the decision has to be delayed.²⁶

²⁶ *Washington Trade Daily*, March 31, 2011.

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.²⁷ 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

²⁷ 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 its 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 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. 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.²⁸

On June 30, 2001, President Bush and then-Prime Minister Koizumi announced the formation of 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.

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.

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 had continued this initiative but in November 2010 established the United States-Japan Economic Harmonization Initiative with Japan, which now operates as the primary forum for discussions.

²⁸ Edward J. Lincoln, *Troubled Times: U.S.-Japan Trade Relations in the 1990s* (Washington, D.C., Brookings Institution Press, 1999), pp. 158-166.

The WTO Dispute Settlement Mechanism

In addition 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 (discussed above). 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.²⁹

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²⁹ Saaida M. Pekkanen, "The Politics of Japan's WTO Strategies," *Orbis*, Winter 2004, pp. 135-147.