Columbia Business School
Center on Japanese Economy and Business

CENTER ON JAPANESE ECONOMY AND BUSINESS

日本経済経営研究所

Working Paper Series

October 2016, No. 355

In the Eye of the Storm

William Rapp

This paper is available online at www.gsb.columbia.edu/cjeb/research

COLUMBIA UNIVERSITY IN THE CITY OF NEW YORK

IN THE EYE OF THE STORM

An Insider's View of US-Japan Trade Negotiations in the Early 1980s

William V Rapp

Professor Rapp is the Henry J Leir Professor of International Business in the Martin Tuchman School of Management at the New Jersey Institute of Technology.

Abstract

There is considerable angst today about the US trade deficit and challenges to the US position centers on China. It is notable that many of these issues echo concerns about Japan in the early 1980s. An analytic review of US negotiations with Japan during the critical period from January 1981 through the Plaza Accord in September 1985 offers a useful reminder of unintended consequences, and of how events can evolve within a context of both micro decisions and larger political and economic forces. This is an insider’s view, as the author was Commercial Counselor at the US Embassy in Tokyo from 1983-85.

Introduction

In the midst of the Cold War during the early 1980s no one in the US government or business community was as concerned with trade issues related to China or Russia as they are today. Rather the focus was on one country: Japan. Many feared it would replace the US as the global economic hegemon, as Ezra Vogel's book Japan as Number One: Lessons for America (1979) suggested.

Japanese Banks were the world's biggest, Japanese auto producers were gaining share both globally and in the United States, and Komatsu was successfully challenging Caterpillar for global mining and construction projects. Cartoons depicted US CEOs dressed in samurai garb and translations of Miyamoto Musashi's 1644 *The Book of Five Rings* sold like wildfire. (Generally accepted as Japan's greatest swordsman, his book is considered a brilliant discussion of strategy.)

Companies, unions, and politicians put pressure on the US government to do something about Japanese competition and the large trade deficit with Japan. Unfortunately, as often happens in the real world, their actions exacerbated the problem. Under pressures to open the Japanese economy to US investors and to appreciate the yen, the Japanese government liberalized the capital controls that had been in place since the end of World War II. But rather than become stronger, the yen remained weak during 1980-85, elevating trade tensions and increasing the bilateral trade deficit with Japan to historic levels. This then became the Eye of the Storm.

Many of the issues raised during this period have echoes today in US trade concerns with China: an undervalued currency, restrictions on capital flows, and the use of bureaucratic tactics to favor local suppliers or support uncompetitive firms.

Thus, an analytic review of US negotiations with Japan during the period from January 1981 through the Plaza Accord in September 1985 offers a useful reminder on how events can evolve within a context of both micro decisions and larger political and economic forces. Trade negotiations inevitably are subject to wider forces of diplomacy and national interest than they are either to the principals of free trade or to concepts of competitive and comparative advantage. Further, they often have unintended consequences.

This is an insider's perspective, as the author was the Commercial Counselor in the US Embassy in Tokyo between 1983 and 1985 and was involved in virtually all aspects of US-Japan trade and business relations during this period. The focus is on the intended and unintended consequences arising from the intersection of politics, economics, and diplomacy with such trade and business related activities including situations involving industrial espionage and cold war priorities.

The core of the paper is a set of summaries of specific cases that provide examples of the various issues. These are organized by the general issue to which they relate. An Appendix presents an overview of the general issues still being contested in the mid 80s when my time as Commercial Counselor ended. ¿[1]

Implementation of the 1980 Foreign Exchange Law

A new foreign exchange law (known officially as the Law Partially Revising the Foreign Exchange and Foreign Trade Control Law) was implemented in December 1980. It changed the basic principle behind foreign exchange control from that of "prohibition of foreign transactions with exceptions" to "freedom of transactions with exceptions". Under the new law, Japanese residents could buy and sell foreign currency assets freely as long as they were dealing with authorized foreign exchange banks and designated securities companies as their counter-parties. However, direct foreign currency transactions among residents and direct financial transactions between residents and non-residents were restricted. (This section draws on Fukao 2015.)

Under this law, foreign currency deposits and foreign currency borrowings with authorized foreign exchange banks became completely free. In addition, the interest rates on foreign currency deposits were exempted from the upper limits of the Temporary Interest Rate Adjustment Law and therefore were free interest rates. Controls on capital transactions could be implemented in certain emergency situations, but controls have never been invoked under the emergency provisions.

The new law enabled residents to freely hold foreign assets and liabilities. This was a fundamental change in exchange controls and was effectively an abolition of virtually all restrictions on the convertibility of the yen. And because the yen became almost fully convertible, non-resident free yen deposits came to be known simply as non-resident yen deposits.

The result was not the intended strengthening of the yen but a further weakening as Japanese insurance companies in particular bought US government securities in huge volumes given the historically high interest rates in the US due to the Volcker Squeeze. (For example, 13-week Treasury bills reached 15 percent in August 1981.) The effect was to increase the demand for dollars and weaken the yen, yielding a foreign exchange gain in addition to a high yield, leading to even more demand for US assets. This demand persisted even after US rates began falling in August 1983 as Japanese insurance companies realized large capital gains on their US bond portfolios. It was only after the Plaza Accord in

[1] Some of the material is covered in Rapp (1999). Rapp (1986) covers several trade barriers in great detail, so they are not repeated here.

September 1985, when the world's central banks coordinated their efforts to weaken the dollar, that the situation was reversed and Japanese dollar investors took a bath.

Specific Cases

Trade-Related Tensions And The Yen

While not all commercially related diplomatic issues involving US-Japan relations between 1980 and 1985 were due to the weak yen, many were. Further, even those that were not directly affected were certainly influenced by it when US firms that could be competitive despite a weak yen were frustrated in selling their products in Japan or that wished to use a strong dollar to invest in Japan but were prevented from doing so. [2]

The hot commercial issues that related directly to a strong dollar include the voluntary auto export quotas, the coking coal controversy, Corning's fiber optic cable sales and patents, integrated circuit (IC) production, and US military procurement.

Cars

The most visible and controversial of these situations were the "voluntary" export restraints on cars whereby, to get around its trade treaties with Japan, the US government compelled the Japanese government and auto producers to limit cars exported to the United States. [3]

---

[2] During this period, Japan imported much fewer manufactured goods than other developed countries. Saxonhouse (1983) analyzed this and concluded that econometrically this import pattern could be explained by the apparent structure of Japan's economy. However, if there are obstacles to trade in certain goods with large internal markets where imports would increase in the absence of these obstacles, the relevant reality that must be addressed is these obstacles and not the question of comparative statistics.

[3] When the US automobile industry was threatened by popular, cheaper, and more fuel efficient Japanese cars, a 1981 "voluntary restraint" agreement limited Japan to 1.68 million cars annually, a level set by the US government. Intended to expire in April 1984, it was extended, albeit with higher limits because of the large trade deficit with Japan and pressure from domestic manufacturers. The restraint was removed only in 1994.

Although gasoline prices had declined from the 1970s, fuel efficiency remained an important factor in many car buyers' decisions.

Initially the Japanese responded by shipping fully equipped cars at a still-lower price than their US counterparts. This strategy not only maximized Japanese revenues per car sold, it undercut the profitable dealer and producer add-ons that were a common US car sales ploy at the time. This, in turn, revolutionized the US marketing of cars.

Export quotas were based on existing market shares, leading Honda, with a relatively low quota, to open a US plant. It was located next to a motorcycle plant in Ohio built to get around quotas on motorcycle imports that the US had imposed to rescue Harley-Davidson. (Klein (1984) discusses the motorcycle case.

Because Japanese producers could charge premium prices for their fully equipped, high-quality, fuel-efficient cars, they and their dealers prospered. Japanese producers used the windfall to develop high-end cars such as the Lexus, Acura, and Infinity, successfully penetrating a market the US thought it had to itself. After 1985 and the Plaza Accord when the yen had strengthened appreciably, these producers also had the cash and market position to follow Honda and establish large, efficient US assembly and engine plants primarily in right-to-work states such as Kentucky and Tennessee.

The FCS (US Department Of Commerce's Foreign Commercial Service) in Tokyo advised US policy makers and representatives of US auto firms in Japan of this likely outcome. However, the firms were focused on the present and their desire to protect eroding US sales, so they pushed hard politically through their Congressional delegations and lobbyists in Washington for the export quotas and their extension. Countering this were the vigorous activities by US state representatives working to attract Japanese auto plants. This included missions led by governors bringing promises of tax holidays and other subsidies. The Commercial Counselor held bi-weekly meetings for the representatives and was able to gauge the increasing excitement and competition for these Japanese investments.

Further, US auto CEOs were misguided on several levels with respect to the competitive and political impacts of the quotas and the US plant investments. Despite the cash flow benefits and state subsidies to their Japanese competitors, the US industry thought that when the Japanese firms set up US operations, it would create a level playing field in terms of wages, benefits, and productivity. However Japanese producers avoided this, hiring a younger work force, which meant lower medical and pension costs. In addition, the Japanese firms built plants that were more efficient, and helped their key Japanese suppliers establish adjacent facilities that were also more up-to-date and efficient than most US counterparts. Perhaps most importantly, these investments also helped the Japanese producers to establish expansive political connections that could act as a counterweight to the Detroit and Michigan delegations. This strategy has been continued by both Japanese and European auto producers as they have expanded investments throughout the South.

Coking Coal

In the early 1980s the Japan's steel industry was considered the world's most efficient, which of course was a great boon to both its auto and shipbuilding industries. Indeed these industries were highly synergistic in that larger ships reduced raw material costs while lower-cost steel reduced the cost of ships and the cost of transporting raw materials. In addition, the development of dedicated car carriers in the 1970s reduced the cost of shipping cars from Japan to the West or East coast of the US below what it cost Detroit to access those markets by truck or rail.

However, Japanese steel producers had no domestic raw material inputs and therefore US coking coal exports to Japan were an extremely important market to an industry that had seen local US coking coal demand decline due to rising Japanese steel imports. Indeed Japan was the US coking coal industry's largest export market. However, due to the strong US dollar, it was losing sales to Australian producers, who also had a shorter shipping route. Nevertheless, given its higher BTU levels, US coking coal remained an important input for Japanese steel producers. Further, these producers were very conscious of their direct and indirect position in the US steel market. The question was then how to raise coal's visibility within the overall US-Japan relationship.

An opportunity to address this arose during the 1984 visit of William E Brock, the US Trade Representative. As a former Senator from Tennessee, a very important coking coal mining and exporting state, coking coal exports to Japan were an area where he had local knowledge and expertise. Having been briefed as he came from the airport for meetings with top Japanese officials, he took to the subject of coking coal imports like a duck to water. The headlines in the Japanese press the next day loosely translated were "Brock Blasts Japanese On Coking Coal!". In turn, the US Coal Association was very happy and it did help jumpstart the negotiations.

Tourism

Due to the liberalization of the yen, Japanese tourists were no longer limited in how much money they could take out of Japan. The US and Japanese governments saw tourism as a way to reduce trade tensions, and the US tourist industry saw a huge market opportunity, particularly in Hawaii. However, the strong dollar made other destinations more attractive. To promote tourism, visa applications were facilitated and the two governments worked to have Japanese tourists pay more of their visits' costs in yen in Japan such as airfares and local tours.

Large Japanese travel companies such as JTB set up operations in Hawaii and the basic strategy actually did work, as Japanese tourism to US destinations increased. But, there were some unexpected

results. Local US tour operators complained they were cut out. And, because Japan is a cash-using society, Japanese tourists tended to carry large amounts of money and became attractive targets for scammers, pickpockets, and muggers. To counter this, consulates began a program to encourage using travelers checks instead of cash, giving flyers in Japanese from American Express and Citibank at the US Consulates when Japanese tourists applied for visas. This brought complaints from Japanese banks that they were being discriminated against, an issue that was finally resolved by also distributing brochures from Bank of Tokyo for its travelers checks.

Depressed Industries

Unfortunately not all trade disputes were so easily resolved. Due to Japan's industrial policy after World War II, the Japanese government felt responsibility toward industries it had promoted but which were no longer competitive. This is similar to China's current treatment of its inefficient state-owned enterprises. Depressed industries included more than 20 officially designated industries, over half of whose operating costs were related to energy and natural resources, that had become uncompetitive due to the dramatic rise in oil prices during the 1970s. (Many studies detail Japan's industrial policy in relation to trade. See Appendix reports 1 and 4, as well as Rapp (1975, 1977).)

These included aluminum smelting, chemical fertilizers, caustic soda, various petrochemicals, lumber, plywood, electric furnaces, and paper. Some (including fabricated aluminum, paper, plywood, and lumber) were protected from a large increase in imports through high tariffs. Others such as chemical fertilizers were import-resistant due to various legal arrangements or industry collusion. The collusion approach included industry safeguards for soda ash, synthetic rubber, and caustic soda firms. The total Japanese market at the time for such products exceeded $80 billion, yet with the exception of aluminum-ingot and electric-furnace products, import penetration was surprisingly low, less than 7 percent.

Historically, the whole purpose of industrial policy had been to move up the value-added chain by promoting the restructuring of Japan's economy and industry toward more sophisticated, higher-technology products, substituting government action for market forces when the latter did not seem to be doing the job. (This is the so-called "flying geese" model of development put forward by Kaname Akamatsu in the 1930s.) These actions had been particularly successful in steel, shipbuilding, and automobiles. However, the protection of uncompetitive depressed industries that had been "favored children" was a new situation and trade issue. It reflected their size and political influence, as well as the slowdown in the Japanese economy during the 1980s as Japan's export-led growth model slowed. When growth is slow it makes it more difficult to transfer resources to emerging sectors.

Still, the Japanese government realized that protecting these industries directly through tariffs or

quotas was risky in terms of trade relations, and could justify other countries protecting their declining industries in ways that hurt Japan's successful export industries. The government thus struck on the idea of giving trade associations or other organizations control over the import and distribution of competitive imports such as fertilizer. Zennoh, the Association of Agricultural Cooperatives, was an excellent illustration of this tactic.

As described in detail in Rapp (1986), Zennoh was the exclusive distributor of chemical fertilizer to Japanese farmers. It could thus import at very low global prices and then mark them up substantially, using the profits to subsidize its own inefficient production. The Japanese consumer picked up the cost in higher food prices. Rice, for instance, was almost seven times the world price. Such high food prices were supported through agricultural quotas that fell outside most trade agreements.

In the case of soda ash used in glass making, the US was able to counter a monopsony by the Japan's Soda Ash Association by setting up a monopoly exporter, ANSAC. ANSAC undertook a campaign to explain to Japanese users such as flat-glass manufacturers the benefits of improved access to US soda ash. [4]

While soda ash was a partial success, little headway was made in opening other depressed industries to more imports. Japanese business, political, and bureaucratic resistance was always very great and therefore each situation took enormous negotiating time and research effort. Thus these highly protected industries only seriously began to disappear as their labor forces aged and as Japanese industry expanded its overseas investment in these industries during the strong yen period that followed the Plaza Accord. One spectacular example of this shift was the dismantling of an entire aluminum production facility in Japan and its reconstruction in Venezuela near a very low-cost hydroelectric facility.

Disputes Over Standards

Aluminum Baseball Bats

In May 1983 changes were made in 16 Japanese laws affecting standards and certification, representing an admission by the government of Japan of how various bureaucratic and industry procedures represented large barriers to trade, violating its international agreements. The US Department of

[4] ANSAC (American Natural Soda Ash Corp) was organized in 1984 with the encouragement of the US Commerce Dept under the Export Trade Act of 1918 (15 USC §61-66), which is more commonly known as the Webb-Pomerene Act. The act grants qualifying export associations a limited immunity from antitrust prosecution. Entities established under Webb-Pomerene are overseen by the Federal Trace Commission (FTC). http://www.ansac.com/about-ansac/company-profile/

Commerce estimated that more than $5 billion in annual trade was affected. The change was stimulated not by a large, critically important depressed industry. Rather, it involved the importing of aluminum baseball bats.

Following a series of injuries resulting from defective metal bats in 1975, none of which were made in America, all metal baseball and softball bats were designated "specified products" under Japan's Consumer Product Safety Law. Thereafter, all metal bats sold in Japan would need to have the "S-mark" labels that certified its product safety. The Japan Softball League (JSBB) also established standards for a "JSBB-mark" for metal bats used in its league games. Although the JSBB standards were in fact based on the US product, US metal bat manufacturers were refused certification by the JSBB when they requested it in 1980. Thus by the fall of 1981 the US government was negotiating intensively with Japan to resolve the issue. A second package of market-opening measures, announced on May 28, 1982, contained a provision stating that any metal bat receiving an S-mark would also receive the JSBB-mark.

Yet this was not the end of the issue because only Japanese producers were allowed factory certification due to the unavailability of Japanese inspectors. US exports were inspected in batches upon import, which was both expensive and time consuming. In response the US argued these procedures violated GATT agreements. The issue was not resolved until the US began a formal dispute resolution process.

In response to pressure for change from the US and other countries, the Japanese government set up a special cabinet-level committee. The Gotoda Commission, under then Chief Cabinet Secretary Masaharu Gotoda would determine the changes required to bring Japan into compliance and resolve some of the standards-related disputes. The findings and recommendations essentially concurred with the US position. As a result, 16 laws were changed.

Tire Valves

One standard that continued to be in dispute was tire valves. Even though Scovill Manufacturing had invented the tire valve and had established the world standard accepted in virtually every country, Japan had a different standard that kept out US valves. Needless to say, given the auto dispute and the number of Japanese-produced cars coming into the US with five tires and five valves plus the large number of Japanese cars and tires being sold locally or exported elsewhere, this was a topic of concern. Further, there was an unexpected political dimension when Ronald Regan was elected president in 1980 and appointed Malcolm Baldrige as Secretary of Commerce.

Baldrige was a past CEO of Scovill and a scion of the founding family. Thus, ahead of a high-level trade mission to Japan led by Baldrige, the Japanese government lifted import restrictions regarding tire valves if they met the international standard, thus accepting imports from the US.

On the day Baldrige arrived with his delegation of top US business executives, headlines in the Japanese press declared that a taxi fleet in Osaka using 250 tires with recently imported US-made valves had all failed. This was so obviously staged that it became a major embarrassment to the Japanese government. Major Japanese tire manufacturers began using US valves in volume, especially on exports to the US, as the US side indicated it might start requiring this by regulation on a quid pro quo basis.

Fire Hose

The leading producer of fire hose worldwide is a company called American Lafrance. Given Lafrance's global scale, the leading Japanese producer was totally uncompetitive. Further the market prospects seemed quite promising, given the developing Japanese construction boom. However, Japanese fire code regulations were quite complex, including the color-coding of fire hoses for different types of buildings and uses. More importantly, the Japanese producer was family owned and one of the family members was a Diet member. In addition, he was on the Diet's construction and building committee and chair of the subcommittee that established fire code regulations. This was an intersection of politics and business interests that could not be overcome. Thus American LaFrance's attempt to enter the country via a joint venture lapsed and Japanese buildings and their tenants continued to bear the higher cost.

Patent Controversies: *Corning*

Corning was the inventor and developer of the fiber-optic technology that has revolutionized telecommunications. Unfortunately the Japanese patent office tied up its application for years and allowed Asahi Glass and Nippon Glass to capture the Japanese market despite multiple US protests and heavy diplomatic pressures. This disagreement finally came to head when the Corning-Siemens joint venture that manufactured fiber optic cable was trying to penetrate the Japanese telecommunications market at the same time that Asahi Glass wanted to open a plant in North Carolina to compete for US business, leveraging the advantages of a weak yen and arguing that Corning's basic US patent had expired.

The US countered that Corning's cable manufacturing and technology patents were still valid and sought to prevent Asahi's investment through a complaint to the US International Trade Commission (ITC) regarding the equipment and technology that Asahi would need to import from Japan. In addition, it linked any resolution of the issue to the granting of Corning's Japanese patents, the payment of past

royalties, and the opening of Japan's telecommunications market to US trade and investment as discussed below. In effect the US was using a hardball strategy out of the Japanese policy playbook – and it worked.

Bureaucratic Hustles

Baxter Travenol

During the 1980s senatorial influence carried sway not only on issues where an important industry was involved, but also where local politics and a single company was the consideration. Baxter-Travenol, headquartered in Illinois, had developed a new portable method for continuous kidney dialysis involving a catheter and a replaceable portable pouch that was not only more convenient for patients than weekly trips to a hospital for a machine-based treatment, but also much less expensive. After a lengthy series of medical trials in cooperation with doctors at some Japanese university hospitals and considerable pressure from the US embassy, including Ambassador Mike Mansfield's direct intervention with Prime Minister Yasuhiro Nakasone, the Japanese Ministry of Health approved the product for widespread use.

This appeared to be a major market opening victory, as well as a victory for Japanese patients, as machine dialysis represented almost 30% of Japan's national health budget. However it also was a huge cash flow for major textile firms such as Toray and Teijin that made the replaceable filters used in the dialysis machines. Machine dialysis was also a big money earner for many hospitals and doctors. Indeed, some hospitals had invested enormously to expand their treatment facilities. Needless to say these economically and politically powerful groups were not happy about having their investments in expensive machines and related facilities less used. Thus, the initial victory proved short-lived.

Under Japan's single payer national health system, getting your medical product or drug approved is a critical first step. However, to make money you also need reimbursement by the system. Normally if a treatment or drug represents an innovation, is a clear patient benefit, and is cost saving, the Ministry will set a reimbursement rate that compensates the supplier for this and encourages doctors to use the treatment or prescribe the drug for a period of years to encourage such innovations and improvements in medical outcomes.

In this case, though, the Ministry set a rate that effectively created a level playing field economically between the machine-based systems and Baxter-Travenol. Thus, there was no financial incentive for doctors to switch to the Baxter-Travenol system. It seemed the industry and the vested interests had won after all. But 1984 was a presidential election year and Charles H Percy was in a tough re-election battle for his Illinois senate seat. Percy came to Japan to meet with his old senate colleague, Ambassador Mike Mansfield. Because Mansfield believed he had solved this issue in direct negotiations

with Nakasone, on hearing of the Japanese ploy, he became visibly upset and arranged for an immediate meeting with the Prime Minister. That afternoon the Commercial Counselor and his industry specialist had a meeting with a Deputy Director at Japan's Ministry of Health that ultimately led to a successful resolution of the reimbursement issue. While this result benefitted Baxter-Travenol and many Japanese patients, Percy lost his seat to Paul Simon.

Hoechst Vitamins

The vitamin market in Japan was and is an extremely large market as Japanese have historically been obsessed with health and fitness. Some observers have even considered Japan to be a nation of hypochondriacs. During this period, the vitamin market was highly protected. The government did this by classifying vitamins as pharmaceutical products similar to medicines that required Japanese medical trials, a very lengthy and expensive process. This situation allowed Japanese producers, and especially Takeda, which had a roughly 60 percent market share, to charge premium prices relative to the world market, where generally vitamins are considered food supplements and a supplier only has to show they met certain quality and chemical composition requirements.

Hoechst, the German chemical company and a dominant player in the world vitamin market, saw Japan as a market opportunity but needed diplomatic and political pressure to break through the strong connections between Takeda and the Ministry of Health. (Many ex-ministry officials occupied important positions at Takeda, as was typical of other Japanese firms and industries such as autos (MITI, the Ministry of International Trade and Industry), steel (MITI), and banking (Ministry of Finance).) Hoechst is a German company and thus went to EU trade negotiators. However the EU had other trade and foreign-direct-investment priorities and declined to help, instead suggesting Hoechst approach the US. Did it make sense for a German company? The answer turned out to be yes.

First, the US was very interested in bureaucratic barriers that violated GATT requirements. Second, one of the Tokyo Commercial Section's mandates was to promote and expand US exports to Japan. Since Hoechst intended to ship the vitamins to Japan from its plant in New Jersey, it met this key consideration. The Ministry of Health was therefore very surprised when the Embassy requested a meeting on the vitamin issue and arrived with the local Hoechst representative. After taking an approach similar to the baseball bat controversy by indicating the US was prepared to file a complaint under GATT with respect to an unwarranted standard being applied to imported vitamins, the Japanese government agreed to a quality testing regime under which Hoechst gained access to the market for its imported products. Takeda immediately lowered prices to meet the competition. Still, the Japanese consumer definitely benefited.

Government Contracts

Access for US suppliers and contractors to Japanese government and government-owned company projects revolved around the application of OECD and GATT agreements on government procurement to which Japan was a party.

Japan generally conformed to the letter of the GATT code in establishing transparent procedures. However, it almost exclusively used sole-source tendering (which was originally intended for exceptional circumstances), effectively undermining the code's intent. Further, a very short 30-day notice period permitted little time for translation and bid response.

An important illustration of both the opportunities and frustrations experienced in this regard was the Japanese telecommunications sector as it moved from analog to digital technology. Japanese suppliers expected that the high prices paid by NTT (Nippon Telephone and Telegraph, the telephone monopoly) and other Japanese customers for domestic equipment as opposed to imports would fund the suppliers' technology and product development.

Telecommunications was typical of many Japanese industries in that, for many years, the government worked closely with leading firms in a sector to promote the industry's development and competitiveness. Indeed, it is the accepted way of doing things in Japan. Close personal relationships in the pursuit of common objectives are naturally developed. This was facilitated by the fact ex-bureaucrats (particularly from MITI and NTT) as noted above populated the higher ranks of the companies with which the ministry and phone company had dealt. The leading suppliers were Fujitsu, Hitachi, and NEC. Both foreign firms and domestic newcomers such as Sony were excluded.

Though value-added networks (VANs, which are private telecommunication systems using leased lines over which special, custom services are offered), telecom-related software, and satellites each involve distinct negotiation problems with different ministries, products, barriers, and negotiation forums, they were all part of an important and complex interaction involving industrial policy, inter-ministry competition, and long-term national strategic objectives with respect to the digitalization of global telecommunications. Thus they were all very visible at the highest levels of business and government on both sides of the Pacific. They represented the industries of the future where each country expected to play a significant leading role (Rapp 1984).

As explained in Rapp (1986), in joint industrial policy forums with the United States at that time, the Japanese government maintained it no longer practiced industrial policies that restricted imports or investment in order to promote domestic industries. Further, it maintained it no longer interfered with the

technology transfers by foreign firms into Japan. Any such policies had been eliminated in the mid-1970s as part of its OECD obligations.

But just after receiving these open-market representations, the US found active proposals by the Japanese government to restrict to 50 percent the foreign ownership of VANs. Similarly, the government refused to purchase US or European communications equipment or satellites, ostensibly to protect domestic space science, but in reality to protect a very uncompetitive space-launch capability.

Finally, MITI tried to set up a new software protection system other than copyright where MITI could have compelled the transfer of US software technology to Japanese firms on terms and conditions determined by MITI. The actually stated rationale was to help Japanese firms catch up with the United States in the area of software development, which was a US competitive strength.

The US government and industry reacted very strongly, with some success. The proposed foreign-ownership restriction was finally eliminated in the VAN legislation. But several onerous proposed regulatory provisions remained, especially for firms offering international VAN services. These concerns were still being hotly negotiated in March 1985, more than a year after the initial discussions began and right up to the promulgation of the new regulations.

In conjunction with Japan's Ministry of Education (which oversaw copyrights), the US was able to persuade MITI to withdraw its proposed software bill. In addition, the purchase of communication satellites by private entities was liberalized as of April 1985. However, other kinds of satellites remained restricted, and NTT had to continue funding Japan’s space satellite programs, reducing its incentive to switch to US purchases. There was further need, as well, for approving an additional band for satellite usage to facilitate the purchase of US communication satellites.

High-technology trade issues thus remained far from full resolution. Market access remained restricted in several ways, and US successes again illustrated that it is generally easier to prevent changes in procedures than to make changes in the existing system. One highly visible success in this regard though was the sale of a $20 million CRAY supercomputer to NTT where CRAY was able to clearly outperform the Japanese entry on several important objective measures.

Industrial Espionage: *IBM Computer Sting*

In the early 1980s IBM dominated the computing world. Thus, in developing their own industry, Japanese producers followed a look-a-like strategy that emulated IBM software. However, as IBM kept moving the technology goal posts, there were tremendous competitive pressures on the Japanese producers such as Hitachi and Mitsubishi Electric to keep up.

The Japanese government could not keep the main competitor out because IBM had had an operation in Japan prior to World War II. Thus, under the Occupation, IBM could return and it made the

most of this opportunity, establishing a strong and vibrant subsidiary. The best the Japanese government could do was to seek to control IBM's market power through laws and regulations that limited the import of technology and which enabled it to force IBM to license its technology to Japanese producers. This proved a Pyrrhic victory though, because it meant diluting market shares of local producers in a high-growth industry where the world leader was a major participant. That, in turn, meant no leading Japanese champion could emerge, thereby compounding the short- and long-term competitive pressures on Japanese producers.

The Japanese resorted to industrial espionage, which led to in a well-publicized and embarrassing sting. In June 1982, four employees of two prominent Japanese companies were arrested by the FBI in the United States for stealing IBM secrets (Pollack 1982, 1983).

The sting was clearly a big setback, but the Japanese simply shifted to a different approach: creating a new and different standard. This had worked for tire valves, among other things.

Protecting Software

In 1984 MITI proposed a new software protection regime other than copyright that would be controlled by MITI. It would have much shorter protection limits than copyright and give MITI access to IBM's proprietary technology. It was obviously supported by Japan's major computer manufacturers such as Hitachi and Fujitsu, who wished to get out from under IBM's effective monopoly of mainframe operating systems standards.

However, under Japanese Law the Ministry Of Education had responsibility for copyrights and wanted to retain this authority. Further, not all important electronics firms supported MITI's initiative. Akio Morita of Sony, in particular, saw his company's future in music and movies being threatened by the MITI proposal and indicated his agreement with US opposition to the scheme. MITI also was unable to generate support from other countries within the World Intellectual Property Organization (WIPRO), except for Korea.

MITI ultimately failed in achieving its goals for reasons similar to the US difficulties in opening certain Japanese industries to competitive imports. When there is an economically and politically powerful unified group supporting an existing regime, and there is no consensus on the side arguing for change, then change is extremely difficult to achieve.

Selling Dual-Use Technologies

During the Cold War the US government was very conscious of valuable technologies becoming available to communist regimes, especially Russia and China. While military technologies related to

armaments were clearly restricted, dual-use technologies applicable to both military and civilian use were also on a restricted list. These included computers, semiconductors, and jet engines.

Being on the restricted list of course made illicit trade in these products quite profitable. One illustration of this that was made public in the Japanese press involved fishing technology from Europe that could be used to identify schools of fish underwater but obviously could be used to track other underwater objects. Two employees of a major Japanese trading company decided to import this product under a European export license with the stated purpose of selling it to a Japanese fishing company.

However their real objective was a diversion to China. The US and Japanese governments discovered the scheme. The Japanese publicly arrested the executives and seized the equipment before it could be shipped. That is, instead of keeping it secret, the incident was used as a warning to Japanese firms considering selling their own dual-use technology products to China or Russia.

Detergent And Paper Diaper Wars

In the late 1970s Proctor & Gamble (P&G) entered the Japanese market with much fanfare through the purchase of a small Japanese company, Sunhome, in conjunction with the trading company C. Itoh. Concerned that this international consumer products giant would overwhelm Japanese competitors such as Kao and Lion, the Japanese government placed several conditions on P&G's entry. As events developed, though, the Japanese government need not have worried.

Kao and Lion took advantage of their established distribution systems and a weak yen to underprice P&G's laundry detergent, Cheer. Further, P&G's traditional marketing strategy of couponing through newspapers was declared illegal as a form of gambling. By 1984 P&G was losing money in Japan at an alarming rate. P&G's CEO sent its executive vice president for International activities, Edwin Artz, to Japan with instructions to stay until the competitive problem was resolved, which was not easy given Kao and Lion's vastly better understanding of the Japanese housewife.

P&G ultimately sought and achieved an innovative non-market solution. Artz and a P&G lawyer arrived at the Commercial Counselor's office proposing to use Japan's Predatory Pricing Act to counter Kao and Lion's aggressive pricing strategies. An artifact left over from the Occupation, the law had been translated from US statutes into Japanese. Still, it remained in force. The law made it illegal for a company to sell its products in Japan below cost with the express objective of driving a competitor out of business.

As this was clearly a sensitive and highly visible situation, the Commercial Counselor arranged a joint meeting with the responsible official at MITI. During this meeting it became apparent MITI did not want to implement the law, but recognized something needed to be done to defuse the conflict. MITI

would thus have discussions with the Japanese firms and work with the US to resolve the couponing and product promotion issues. In this way the situation was quietly resolved. Artz could return home after bringing in new management for the Japanese operation. He eventually became the CEO of P&G.

Importantly, the Japanese use of government guidance in this case resolved a commercial dispute quickly and efficiently, unlike the US where lengthy and expensive litigation would be much more likely.

Nevertheless it was clear that P&G's standard approach to international expansion was far too simplistic in just replicating its US or UK operations in such a different cultural context as the Japanese market. This became apparent in the diaper wars that occurred about the same time. P&G invented the disposable paper diaper, Pampers, and successfully introduced them into Japan by distributing them free to major maternity hospitals.

But subsequently its Japanese market share dropped from 100% to 15% as Kao in particular introduced a product that not only was superior in all respects, but also showed far greater understanding of the Japanese housewife. Unlike Pampers, Kao put elastic around the bottom of the diapers so they would not leak and blue dots that changed color when the child had peed, thus alerting a mother as to when the diaper needed changing. P&G merely responded by lowering its price and couponing, but to no avail. It would then take several years and a revamping of its Japanese operations to stabilize and grow its Japanese business, an object lesson in corporate hubris.

Banking, Financial, and Legal Services

One aspect of the Chenery (export-led) growth model is that when lower growth arrives, the economy should be prepared to transition into a more consumer-service based economy. A key aspect of this economic evolution, which the Japanese and the US both clearly understood, is the importance of communications and software and their electronic support structure. This was the basis of the strategic clashes described above.

A key part of the transition is the industries that are the major users of the new technologies. Financial services and their legal and accounting support services thus loomed as critical to the development of a consumer-, information-, and service-led economy. As the large accounting firms such as Arthur Anderson and Price Waterhouse had been grandfathered since the Occupation, market opening negotiations focused on banking, investment banking, and brokerage, along with legal services.

Universal banks from Europe were seen as having an advantage compared to US banks, which were subject to Glass-Steagall restrictions on the range of services they could offer. The Occupation had instituted a similar separation of banking and security services in Japan. The large Japanese banks hoped to use international investment as a way around the restrictions. Everyone was jockeying for position,

while the regulatory environment became quite fluid. In the end US, Japanese, and European regulators let almost everyone into the competitive mix with unforeseen consequences.

One key decision was a regulatory opinion by the US Federal Reserve that Glass-Steagall only compelled the separation of commercial and investment banks in the United States and did not prevent a US bank from owning or participating in securities and investment banking activities in other countries. This set off a wave of purchases by US commercial banks of UK and Hong Kong securities firms that had, or had the right to open, offices in Japan. Because the UK was not burdened with defense-related considerations in negotiations, it had been very aggressive in demanding a quid pro quo from the Japanese when Japan's major banks and securities companies wanted to open offices in London, the world's major financial center.

These acquisitions were not cheap because, on top of the cost of buying or establishing a UK securities firm, the Ministry of Finance (MOF) required that the Japanese subsidiary be adequately capitalized and that it had a full staffing complement in terms of officers, compliance, and reporting personnel and traders. This not only kept headhunters busy, it gave second careers to Japanese bank and securities personnel nearing retirement. Demand for prestigious office space also increased dramatically. Indeed it was difficult to keep up with the opening of new securities operations.

The demand for related legal services also grew, and the expanding US and UK financial firms pressed their case that they needed in-country advice from their traditional lawyers. This was naturally something the Japanese legal profession aggressively resisted, abetted by US firms that had been founded by US lawyers during the Occupation such as Anderson, Mori & Rabinowitz. These firms were concerned that they would lose existing large clients operating in Japan and would be overwhelmed by the larger and better-financed US and UK law firms. A compromise was finally reached where large foreign law firms could apply to open two-person representative offices that would only be able to opine to their clients on international or foreign law. Further they were not allowed to hire Japanese lawyers or to merge with a Japanese law firm.

This arrangement lasted for a few years but, like the proverbial camel getting its nose under the tent, the large global firms eventually were allowed to merge with Japanese law firms or to hire Japanese lawyers, effectively becoming full-service branches.

The newly minted securities firms did not fair so well. By the time they got their operations under way, they were hit with the 1987 market crash, followed by the collapse of the Japanese stock and real estate markets in the first quarter of 1990. In addition, it had proved quite difficult to break down traditional Japanese banking and securities relationships. As a result, few of the new security operations made any money, even during the boom period. Though Japan ultimately became more open to big global financial service firms, many wrote off their security firm investments and began focusing on the next big

opportunities – the collapse of the Soviet Bloc, the opening of China, and the huge surge in foreign direct investment in Southeast Asia.

Fishing

Once a year, senior officials from the Economics section of the US State Department, along with senior officials from the Department of Commerce, would meet with their Japanese counterparts to discuss, and in some cases negotiate, the economic and commercial issues between the two countries. Given its heavily fish-based diet, one of the most important topics from the Japanese viewpoint was access to fishing rights within the US 200-mile economic zone, especially off the coast of Alaska. These negotiations covered a range of issues including the number of boats in the Japanese fishing fleet and the types and quantities of fish that could be caught. In 1984 these negotiations became extremely heated.

US fishing interests wanted access to Japan's surimi technology, a product that looks and tastes (something) like Alaskan king crab. In addition, Congress had passed legislation that linked the granting of US fishing rights with specific limits on whaling, an issue that particularly targeted Norway and Japan. By linking access to critical US fishing areas with whaling, US environmental groups hoped to pressure Japan into limiting its whaling. The Japanese side was not happy about this because one specific community in Japan was totally economically dependent on whaling. At one point in the discussions, a Japanese vice minister stated that if the US persisted in linking fishing rights and whaling, it could jeopardize the entire US-Japan relationship including defense. While it was recognized this was rhetoric for public consumption, it was still a shock to hear such a statement given that Prime Minister Nakasone had not long before referred to Japan as the US's giant aircraft carrier.

The US ultimately got the surimi technology, and the Japanese continued whaling but for "scientific" rather than "commercial" purposes.

Conclusion

While the above scenarios are by no means comprehensive in terms of the commercially related controversies between the US and Japan during the 1980s and later, they do reflect the scope and various nuances that arose. Importantly, they have echoes in current trade and investment disputes with China that also are taking place within a complex of larger diplomatic and military interests. Perhaps the successes and failures of the processes described above will be useful in addressing similar issues when they arise in another time and place. That they no longer are issues with respect to Japan should be a caution that as economies change, so can related economic and political tensions.

Appendix: Invisible Barriers to Trade Remaining in the Late 1980s

Given the number of available examples, there are, commensurately, a large number of detailed studies of the complaints of foreign businesses in Japan dating from the 1980s. The result of this increased transparency of trade barriers, combined with pressure from foreign governments, did lead to the reduction and elimination of some of the practices. However, several remained in the mid 80s when my time as Commercial Counselor ended. They are outlined below by both general area and specific industry. More detail is included in the reports cited.

There has been no attempt to eliminate overlap among categories. When the same problem appears in more than one sector, it indicates a particularly difficult problem for an industry specifically and for several products generally. Barriers to investment are included with trade barriers, as investment is considered a key contributor to facilitating imports into Japan and to improving a firm's competitive position.

Barriers such as language or the distribution system are mentioned only when government action could ameliorate the situation. Otherwise they are innate to Japan's business environment and just have to be dealt with.

Generic problems affecting a broad range of goods and services

Standards code

Japan passed 16 laws in May 1983 to permit more foreign participation in the standards-setting process, and it seems to comply with international procedures on prior notification in creating or revising standards. However, ministries still did not have a procedure for accepting foreign test data in many areas, including industrial standards, pharmaceuticals, and medical equipment. Only two US firms had been designated as foreign testing organizations, and none could do the initial tests for JIS [Japanese Industrial Standards similar to US UL or Underwriters Laboratories] marks. Self-certification also remains elusive, particularly in areas such as automobiles. Thus, five years after this problem was first raised as a non-tariff barrier, and two years after the laws were passed to achieve needed changes and a Japanese cabinet level commission recommended significant, if not sweeping changes, there still had been very little effective implementation of improvement.

In areas such as telecommunications, foreign firms still had not been granted access to the ministry's deliberative council in which standards are discussed and set, even though Japanese law

required such participation. Thus standards issues remained an important impediment to increased imports. (See reports 1, 5, and 7.)

Customs-valuation

The problem of uplifting assessment valuations in related-company transactions (transactions in which goods move between company offices) is one of raised duties and discouraged imports. Similarly, costly clearance delays could be significantly reduced by permitting the increased use of bonded warehouses, publishing clear customs procedures, allowing goods to clear customs on bond with subsequent settling of duty payments, eliminating various permit systems, and clarifying the fees involved. Also, there is no customs duty-drawback provision when a product is re-exported.

Establishment of a transparent import-licensing code

Japan had not taken action to comply with or implement such a code despite provisions in the amended 1980 Foreign Exchange and Trade Control Law. Import restrictions still were being added or deleted by administrative guidance, and import quota allocations were not transparent. Thus, all applicants did not have an equal chance to compete. As some quotas were not fully utilized, this was an area of some concern, as was the introduction of administration practices without due process.

Government-procurement

Japan conformed to the letter of the GATT code, especially in establishing transparent procedures for government procurement. However, the extensive, almost exclusive, use of sole-source tendering (which was originally intended for exceptional circumstances) almost vitiated the code's intent in terms of opening the Japanese government-procurement market. In addition, some administrative obstacles remained, such as the 30-day notice period, which is the GATT minimum, and Japanese maximum, thereby permitting little time for translation and bid response. (See reports 1, 4, and 7.)

Intellectual property

Inventions, brand names, corporate symbols, product styling, proprietary know-how, and so on are highly valuable assets to any corporation. They are often the only entry advantage to a potential foreign importer or investor. This means protecting that advantage becomes a critical part of any market-entry or market-

development strategy. Therefore, the net impact of Japan's administration, laws, and procedures in the area of patents, trademarks, and copyrights has a material and, unfortunately, generally adverse impact on foreign firms' competitive position in Japan.

The large number of applications combined with the Patent Office's limited resources to create the biggest problem concerning intellectual property. There were four times as many patent filings as in the US, and applications could take four to six years to be processed.

Patent applications are open for public inspection after 18 months, and the patent period runs from the application date. The ability of Japanese firms (often those seeking to develop a similar technology) to borrow the patent file opens an applicant to potential technology loss during the critical initial market development period. Further, the Japanese firms can delay the patent through objections. This situation discourages both trade and investment.

The Japan Patent Office also did not offer foreign firms sufficient time to file applications based on their overseas patents, given the problems of translation. Further, the Patent Office rejected applications for minor errors of commission or omission rather than granting an extension to revise the application.

Trademarks offer a similar area of concern, given long delays, the ability of Japanese firms to register foreign trademarks in Japan, and the difficulty in renewal if minor changes have been made. Also, Japan's trademark protection did not extend to service marks. And there was no protection in Japan for trade secrets or industrial know-how.

(See reports 3, 4, and 7.)

Academic discounts

These discounts are a specialized form of market promotion aided by a provision in the tax code that permitted the difference between a product's list price and its sale price to an educational institution to be deducted for tax purposes. Depending on the list price and a company's marginal tax rate, the practice allowed a firm to sell at a profit due to an effective tax subsidy, even when the discounted sale price was below cost.

The Ministry of Education often used the existence of academic discounts to justify sole-source tenders, even though the source of the discount was from government funds via reduced tax revenues. As local earnings are needed to take advantage of the tax provision, and the pool is limited to a percentage of earnings, the effect was to favor large Japanese companies at the expense of importers. This discount was an especially important advantage in selling such items as super-computers and expensive medical equipment to university laboratories and hospitals. Such sales in turn helped establish a strong market

position for Japanese firms in these high technology, innovative products.

Industry-Specific Measures

Industry-specific measures affecting foreign sales of goods and services are often, but not always, involved in issues of industrial policy. In these cases, market-opening measures become intertwined with issues of fairness, long-term government objectives, and targeting changes in comparative advantage. I endeavor to distinguish in the following list between those areas where barriers are considered part of Japan's industrial policy objectives at the time (marked with an *) and areas where barriers are more the result of historical accident.

*1.*Agricultural chemicals:* See reports 3 and 7.
*2.*Automobiles:* See reports 2, 5, and 7.
3.*Banking and securities:* See reports 2, 3, 5, and 7.
*4.*Biotechnology:* See report 7.
* 5.*Chemicals:* See reports 2, 3, and 7.
* 6.*Computers and software:* See reports 1 and 7.
7.*Construction/ engineering firms:* See reports 2 and 3.
8.*Cosmetics:* See reports 3, 5, and 7.
*9.*Depressed industries:* See reports 1 and 7.
*10.*Energy:* See reports 2 and 3.
11.*Food products:* See reports 5 and 7.
*12*Forest products:* See reports *5* and 7. 18.
13.*Insurance:* See reports 2, 3, and 7.
14.*Legal services:* See reports 3 and 7.
*15.*Pharmaceuticals and medical equipment:* See reports 2, 3, and 7.
16.*Publishing:* See reports 2, 3, and 7.
*17.*Semiconductors:* See reports 1 and 7.
*18.*Telecommunications products and services:* See reports 1, 3, and 7.
19.*Tobacco products:* See reports 5 and 7.
20.*Transportation:* See reports 2, 3, and 7.

Reports

1. Advisory Council on Japan-US Economic Relations. "Background Study: The Trade Effects of Japan's Industrial Policies: An American Business Perspective". Unpublished paper. Washington DC: June 15, 1984.

2. American Chamber of Commerce in Japan. "Investments Committee Report on 1981/82 Trade/Investment Barrier Membership Survey". Unpublished paper. Tokyo: March 8, 1982.

3. American Chamber of Commerce in Japan, "ACCJ Trade/Investment Barriers Survey Follow-up (1983)". Unpublished paper. Tokyo: March 8, 1983.

4. Japan-US Businessmen's Conference. *Understanding the Industrial Policies and Practices of Japan and the United States: A Business Perspective.* Washington DC: July 1984.

5. Office of the United States Trade Representative. "Japanese Barriers to US Trade and Recent Japanese Government Trade Initiatives". Unpublished paper. Washington DC: November 1982.

6. Lionel Olmer. Testimony Before Senate Foreign Relations Committee, "US-Japan Trade Deficit". Washington DC: October 1984

References

Fukao, Mitsuhiro. 2015. Capital account liberalization: the Japanese experience and implications for China. Bank For International Settlements, BIS Papers 15. www.bis.org/publ/bppdf/bispap15h.pdf

Klein, Daniel. 1984. Taking America for a Ride: The Politics of Motorcycle Tariffs. Policy Analysis 32. http://www.cato.org/pubs/pas/pa032.html

Levin, Eric. 1982 Mar 05. The IBM Case Arches Eyebrows in Silicon Valley, Where High-Tech Spying Is 'a Way of Life'. People, vol 18 # 5. http://www.people.com/people/archive/article/0,,20082780,00.html

Miyamoto Musashi. 1644. *The Book of Five Rings* (*Go Rin no Sho*). Available as a free PDF download from various web sites.

Pollack, Andrew. 1982 Sep 19. The Far-Flung Wars of Mighty IBM, New York Times. http://www.nytimes.com/1982/09/19/business/the-far-flung-wars-of-mighty-ibm.html
Pollack, Andrew. 1983 Nov 05. The Publicity Effect of I.B.M. 'Sting'. New York Times. http://www.nytimes.com/1983/11/05/business/the-publicity-effect-of-ibm-sting.html

Rapp, William V. 1967. "Theory of Changing Trade Patterns Under Economic Growth: Tested for Japan". Yale Economic Essays. Fall 1967, p 69-135.

Rapp, William V. 1975. "Japan's Industrial Policy". In Isaiah Frank, editor, The Japanese Economy in International Perspective, p 37-66. Johns Hopkins University Press.

Rapp, William V. 1977. "Japan: Its Industrial Policies and Corporate Behavior". Columbia Journal of World Business, Spring 1977, p 38-48.

Rapp, William V. 1984 Aug. Unbundling Japan Inc. Creative Computing 10 (8):43. http://www.atarimagazines.com/creative/v10n8/43_Unbundling_Japan_Inc.php

Rapp, William V. 1986. Japan's Invisible Barriers To Trade. In Thomas A Pugel and Robert G Hawkins, editors, Fragile Interdependence, p 21-45. DC Heath. https://web.njit.edu/~rappw/C-031.pdf

Rapp, William V. 1999. Foreign Firms in Japan's Securities Industry in the 1980s and Post Bubble Economy. In Raj Aggarwal, editor, Post Bubble Japanese Business, ch 7. Kluwer Academic Publishers.

Saxonhouse, Gary. 1983. "The Micro- and Macro-Economics of Foreign Sales to Japan". In William R Cline, editor, Trade Policy in the 1980s. Institute for International Economics.

Vogel, Ezra. 1979. Japan As Number One: Lessons For America, Harvard University Press.