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## **The Rising U.S. Trade Deficit With Japan: Overview and Policy Options**

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### **Summary**

The U.S. merchandise trade deficit with Japan reached \$73.9 billion in 1999. It is the largest bilateral deficit with any U.S. trading partner. In addition to the growing deficit in goods trade (with almost all accounted for by trade in machinery and transportation equipment), the bilateral deficit in investment income also has become unusually large — so large that it outweighs the U.S. surplus in services trade with Japan. As a result, the bilateral current account deficit — \$75 billion in 1998 — exceeds the merchandise trade deficit with Japan. Options for dealing with this deficit include letting market forces cope with it, raising the value of the yen, opening export markets in Japan, increasing U.S. investments in Japan, and reducing U.S. imports from Japan. This report will be updated periodically.

### **Trade in Goods**

The U.S. trade deficit in goods (merchandise) with Japan rose to \$73.9 billion in 1999, up from \$64.0 billion in 1998. The trade deficit with Japan is the largest that the United States incurs with any of its trading partners — including the \$68.7 billion deficit with China. For 1999, the deficit was generated by U.S. imports of goods from Japan of \$131.4 billion and U.S. exports to Japan of \$57.5 billion. In short, the United States buys more than twice as much in goods from Japan as it sells there. The trade deficit with Japan accounts for about a quarter of the overall U.S. merchandise trade deficit of \$347.1 billion.

Figure 1 shows U.S. exports to, imports from, and the U.S. trade balance in goods with Japan over the past two decades. As can be seen, the deficit has fluctuated around \$50 billion since the mid-1980s and has been growing since the mid-1990s. Changes in the level of the deficit appear to be caused by changes in the yen-dollar exchange rate, in macroeconomic conditions in the two countries, and in competitive conditions in certain industries. In general, a strengthening of the yen (making imports from Japan more expensive) has been followed by a drop in the level of the deficit in ensuing years, while a weakening of the yen has had the opposite effect of increasing the deficit. When the

U.S. economy is growing faster than Japan's, the bilateral deficit tends to grow, and vice versa. In recent years, Japan's economy has been in recession, while the U.S. economy has been growing.

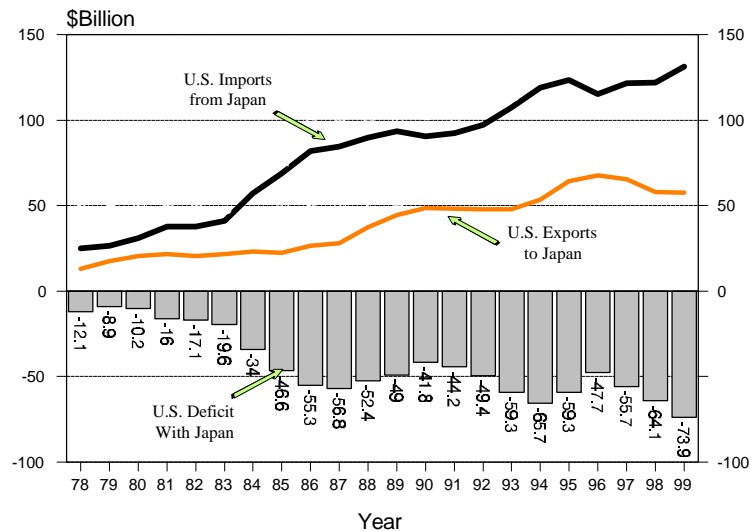
As shown in Figure 2, virtually all the trade deficit with Japan can be accounted for by trade in machinery and transportation equipment. In 1999,

the United States imported \$99.4 billion while exporting \$24.1 billion of such products to Japan for a sectoral deficit of \$75.3 billion. This included trade in motor vehicles, aircraft, and machine tools. There also were deficits of \$4.8 billion in miscellaneous manufactured articles and \$4.9 billion in manufactured goods classified chiefly by material. On the other hand, the United States ran a \$14.8 billion surplus in trade with Japan in food, live animals, beverages, tobacco, and inedible crude materials.

The U.S. trade imbalance with Japan arises primarily from trade in a handful of products in which imports are exceptionally large. As shown in Table 1, the list of major U.S. imports from Japan is headed by motor vehicles, office machines, electronic components, and communications equipment. These four categories account for approximately half of all U.S. imports from that country. Imports of motor vehicles and parts, in particular, have been running in

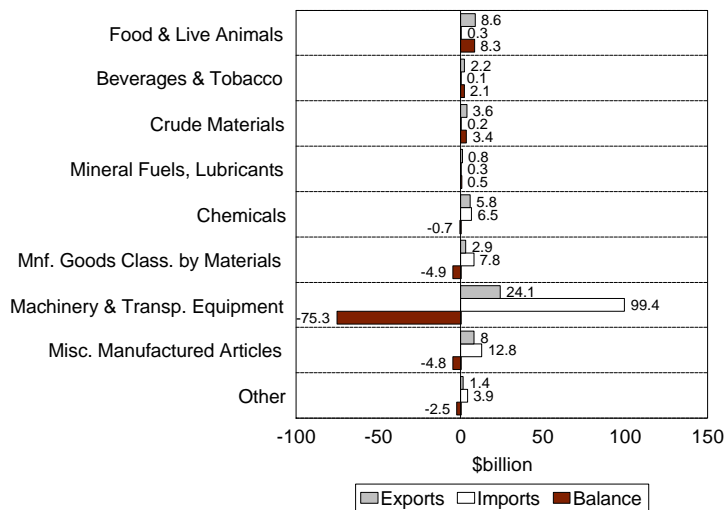
excess of \$9 billion per quarter and have been rising since early 1997. Despite considerable investment by Japanese automakers in production capacity in the United States, at \$39.5 billion in 1999, motor vehicles/parts remain the largest single product imported from Japan. They are followed by computers/ office machines, electronic components and accessories, and communications equipment. Other categories in which imports have been increasing include communication equipment, audio/television

**Figure 1. U.S.-Japan Merchandise Exports, Imports, and Trade Balances, 1978-99**



Source: Data from U.S. Department of Commerce

**Figure 2. U.S. Trade With Japan by Major Commodity Classification, 1999**



Source: U.S. Department of Commerce

equipment, construction machinery, and engines/turbines. Imports have been declining in photographic equipment and special industry machines. Steel mill product imports from Japan rose from \$0.508 billion in first quarter 1997 to \$0.906 billion in third quarter 1998 and fell to \$0.368 billion in fourth quarter 1999 as antidumping duties were imposed on imports of hot rolled sheet and steel plates.<sup>1</sup>

<b>Table 1. Major U.S. Imports from Japan, by 3-digit SIC Codes Quarterly/Annual, 1997-99, Million Dollars</b>												
SIC	Description	1997	1998					1999				
		Total	1st	2nd	3rd	4th	Total	1st	2nd	3rd	4th	Total
371	MOTOR VEHICLES AND MOTOR VEHICLE EQUIPMENT, AND PARTS	33,484	8,688	8,336	8,477	9,246	34,747	9,906	8,961	9,639	10,964	39,470
357	OFFICE, COMPUTING, AND ACCOUNTING MACHINES, AND PARTS AND ACCESSORIES	15,351	3,411	3,438	3,348	3,476	13,672	3,275	3,342	3,727	3,813	14,157
367	ELECTRONIC COMPONENTS AND ACCESSORIES	11,502	2,602	2,291	2,286	2,466	9,645	2,355	2,470	2,687	2,983	10,495
366	COMMUNICATIONS EQUIPMENT AND APPARATUS	3,938	1,106	1,101	1,193	1,203	4,604	1,195	1,418	1,705	1,847	6,165
386	PHOTOGRAPHIC EQUIPMENT AND SUPPLIES	4,831	1,140	998	1,029	983	4,150	1,008	886	963	992	3,849
354	METALWORKING MACHINES AND EQUIPMENT, AND PARTS, ACCESSORIES AND ATTACHMENTS	4,059	970	991	1,013	988	3,962	907	882	835	806	3,429
365	RADIO AND TV RECEIVING SETS; PHONO-GRAPHS; RECORDERS; MICROPHONES; LOUDSPEAKERS; AUDIO AMPLIFIERS; & OTHER AUDIO EQUIPMENT & ACCESSORIES	2,614	641	700	759	726	2,826	686	761	841	788	3,075
369	ELECTRICAL MACHINERY, APPARATUS, AND PARTS	3,006	728	723	742	757	2,948	746	758	846	907	3,257
382	INSTRUMENTS FOR MEASURING, DETECTING, TESTING, AND/OR CONTROLLING NONELECTRIC QUANTITIES, AND PARTS & ACCESSORIES	2,546	713	650	630	621	2,613	684	706	767	857	3,014
356	GENERAL INDUSTRIAL MACHINES AND EQUIPMENT, AND PARTS AND ATTACHMENTS	2,359	636	587	540	606	2,369	661	674	752	872	2,959
353	CONSTRUCTION, MINING, AND MATERIALS HANDLING MACHINERY	1,705	538	573	440	438	1,988	620	618	420	377	2,036
394	TOYS AND SPORTING, ATHLETIC, AND GYMNASIUM GOODS, APPLIANCES, APPARATUS OR ACCESSORIES	2,592	371	538	525	1,141	2,575	380	499	722	917	2,517
351	ENGINES AND TURBINES, AND PARTS AND ACCESSORIES	1,265	342	350	352	400	1,444	457	473	502	586	2,018
286	INDUSTRIAL ORGANIC CHEMICALS	1,933	514	487	449	484	1,934	451	467	448	539	1,905
283	DRUGS	1,203	359	396	369	337	1,461	366	447	524	500	1,837
362	ELECTRICAL INDUSTRIAL APPARATUS	1,586	382	367	347	342	1,438	372	448	522	464	1,806
372	AIRCRAFT AND PARTS	1,646	412	494	485	492	1,882	427	431	449	390	1,697
355	SPECIAL INDUSTRY MACHINES AND EQUIPMENT, AND PARTS, ACCESSORIES AND ATTACHMENTS	2,370	591	561	447	424	2,023	448	421	426	491	1,786
331	BLAST FURNACE, STEEL WORKS, ROLLING MILL, AND FINISHING MILL PRODUCTS	1,807	602	783	906	898	3,189	511	412	411	368	1,702
Note: SIC=Standard Industrial Classification. Data are on a Census basis. Source: U.S. Department of Commerce												

## Trade in Services and the Current Account

The United States runs a surplus in services trade with Japan, but that surplus amounted to only \$16.5 billion in 1998 as contrasted with the \$65.3 billion deficit on goods. (Details of services trade and the current account for 1999 are to be announced

<sup>1</sup>See: CRS Issue Brief 10023, Steel Imports: Effects on U.S. Industry and Proposed Legislative Remedies, by Gwenell L. Bass.

in March 2000.) The combined balance on goods and services totaled \$48.7 billion in 1998, up \$10 billion from that in 1997, but still below the record \$51.7 billion in 1994.

**Table 2. U.S. Trade and Balances with Japan in Goods, Services, Investment Income and Current Account, 1994-98 (million dollars)**

Year	U.S. Exports		U.S. Imports		Balance on Goods	Balance on Services	Bal. on Investment Income	Balance on Current Account
	Goods	Services	Goods	Services				
1994	51,813	29,556	119,137	13,920	-67,324	15,637	-11,014	-62,841
1995	63,108	34,376	123,453	15,108	-60,345	19,268	-15,738	-56,939
1996	65,961	34,148	115,171	14,060	-49,210	20,088	-16,214	-45,470
1997	64,599	35,014	121,658	15,470	-57,059	19,544	-25,214	-62,886
1998	58,595	31,737	121,850	15,197	-65,255	16,540	-26,443	-75,354

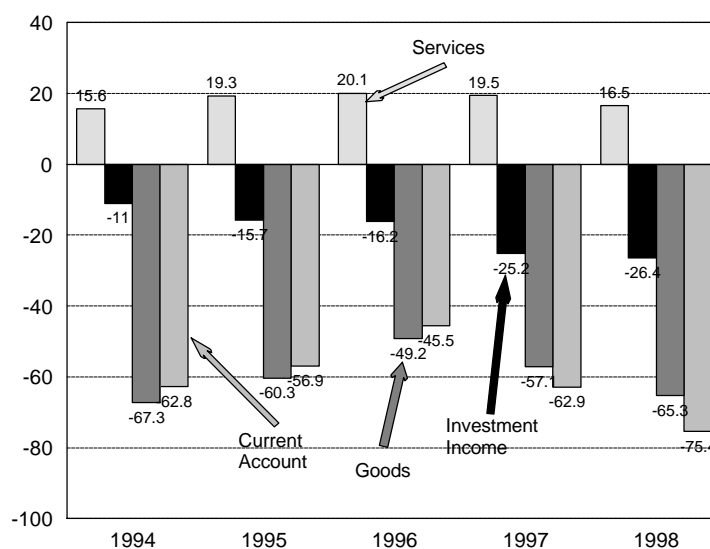
Source: U.S. Department of Commerce. *Survey of Current Business*, various issues.

Note: Data are on a balance-of-payments basis.

The balance on current account is considered to be a broader measure of the trading relationship between two countries. It includes trade in goods and services as well as unilateral transfers (e.g., remittances from immigrants) and the balance on income from U.S. assets abroad and foreign-owned assets in the United States. As shown in Figure 3, the current account deficit with Japan recently has grown larger than the deficit in goods trade.

The deficit on current account did decline from \$62.8 billion in 1994 to \$45.5 billion in 1996 but grew to \$75.4 billion in 1998. The expanding negative balance in goods trade, of course, contributed to this increase, but the burgeoning deficit in income from investments also has become significant. This is resulting from the fact that the United States has become a net debtor nation — foreigners, particularly Japanese, have invested more in the U.S. economy than Americans have invested abroad. The net earnings flow from investments, therefore, has grown progressively larger in favor of Japan. Prior to 1997, the U.S. surplus in services outweighed the deficit in investment

**Figure 3. U.S. Balances with Japan in Goods, Services, Investment Income, and Current Account, 1994-1998 in billion dollars**



Source: Data from U.S. Department of Commerce

income and made the current account deficit smaller than the goods trade deficit. Since 1997, this has been reversed. The U.S. deficit in investment income now outweighs the U.S. surplus in services trade with Japan.

At the end of 1998, Americans had holdings of \$38.2 billion in direct investments (where investors have a controlling interest in the enterprise) in Japan, while Japanese had direct investments of \$132.6 billion in the United States. In private holdings of stocks and bonds, Americans had investments of \$150.7 billion in Japan while Japanese had \$190.4 billion in the United States.<sup>2</sup> At the end of 1998, Japanese government and private investors also held \$292.6 billion in U.S. Treasury Securities.

## Policy Options

Mainstream economic analysis of international trade flows pays little heed to imbalances with individual trading partners. At any point in time, trade with some countries will be in deficit while trade with others will be in surplus. In the United States and other countries with relatively liberalized trade and capital flows, moreover, trade imbalances tend to be influenced mostly by macroeconomic factors, such as capital flows (resulting from differences in saving rates), exchange rates, and relative growth rates.<sup>3</sup> With Japan, however, the bilateral trade deficit is unusually large, chronic, and has at times become a flashpoint for trade friction. The macroeconomic flows, moreover, are influenced greatly by the existing structure of trade. This structure includes protection of certain industries, such as rice farming, in Japan. Changing the trade structure, would change specific trade flows which, in turn, could affect macroeconomic variables such as savings and investment. If Japan allowed more imports of rice, for example, the savings rate of Japanese farmers would probably fall. U.S. trade policy also can affect specific trade flows. In 1998-99, for example, U.S. antidumping duties on Japanese steel cut such imports in half. U.S. exchange rate and monetary policies, moreover, affect the relative value of the yen as well as U.S. growth rates which, in turn, affect trade balances.

The policy options dealing with the bilateral trade deficit with Japan primarily would be to: (1) let market forces prevail, (2) raise the value of the yen, (3) open markets in Japan further, (4) increase U.S. investments in Japan, (5) reduce U.S. imports from Japan, and (6) encourage Japan to raise its economic growth rate.

The vast majority of the trading transactions between the United States and Japan are governed by market forces. The trade and capital flows are so large that any government intervention into the market, of necessity, would be at the margin. Still some policy options are available.

Raising the value of the yen (or not intervening to stop its appreciation) is a policy apparently being pursued by the United States. The value of the yen has risen from 131 yen per dollar in 1998 to about 105 yen per dollar at the end of 1999 and around 109 yen

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<sup>2</sup>Scholl, Russell B. The International Investment Position of the United States at Yearend 1998. *Survey of Current Business*, July 1999. p. 45.

<sup>3</sup>For discussion of trade deficits, see: CRS Report RS20364, *America's Growing Current Account Deficit: What Does It Mean for the Economy?* By (name redacted) and CRS Report 98-693 E, *The U.S. Trade Deficit: Trends, Theory, Policy, and Sustainability*, by (name redacted).

per dollar in February 2000. Part of this appreciation is being caused by capital flowing back into Japan as it recovers from recession. The Japanese government has been actively intervening in foreign exchange markets to counter this appreciation. Its holdings of foreign exchange (obtained by selling yen) have risen from \$185 billion at the end of 1995 to \$215 billion at the end of 1998 and further to \$293 million dollars billion at the end of January 2000. Over the past year, Japan has been weakening the yen by purchasing dollars and other foreign currencies at the rate of about \$5 billion per month. Yet it is a stronger yen that is instrumental in reducing Japan's trade surplus. How effective this intervention has been in weakening the yen is an open question, but it indicates that the Japanese government is taking fairly aggressive action to sustain its trade surplus.

Opening markets in Japan to U.S. exports and investment has long been pursued by the United States.<sup>4</sup> Although considerable progress has been made, access in some sectors is still in dispute. These include insurance, glass, photo film, and several agricultural products. Japan's banking crisis and recession has opened the way for more foreign participation in its financial markets, but the combination of past investment barriers and the high cost of entering the market has worked to keep the level of foreign investment in Japan relatively low. This imbalance in investment relations contributes significantly to the deficit in investment income with Japan.

Under U.S. trade law, protection of specific U.S. industries from import competition from Japan is possible for three basic purposes: (1) to act against dumping (exporting a product at a lower price than in the home market), (2) to counter the effects of government subsidies, and (3) to take "safeguard" action in response to an injury or threatened injury to a U.S. industry caused by a surge in imports. As of December 1999, the United States had 34 antidumping duty orders in effect on products from Japan. These included hot rolled steel, stainless steel sheet and wire rod, vector supercomputers, forklift trucks, color picture tubes, and drafting machines. Since the late 1970s, the United States has imposed no countervailing duties for subsidies on products from Japan. After the U.S. automobile industry lost its case in the early 1980s, safeguard action has been rarely used in trade with Japan.

When the Japanese economy grows faster, it tends to draw in more imports, including products from the United States. Throughout 1997 and 1998, the United States encouraged Japan to pursue more aggressive fiscal and monetary policies and to ease government regulations in order to stimulate its economy. In 1999, the Japanese economy had begun to show signs of recovery, but late in the year dropped into negative growth again. Much of the growth that did occur could be attributed to government spending.

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<sup>4</sup>For a summary of these trade negotiations see CRS Issue Brief 97015, *U.S.-Japan Economic Ties: Status and Outlook*, by (name redacted).

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