Is U.S.-Japan Trade Friction Avoidable?

Blaming Trade Partners for Deficits Is Pointless

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The new U.S. administration inaugurated in January 2017 is moving to restrict international trade by pursuing protectionist trade policy. Upon taking office, President Donald Trump declared his intention for the United States to withdraw from the Trans-Pacific Partnership (TPP) agreement and renegotiate the North American Free Trade Agreement (NAFTA). Furthermore, media reports show that the administration is moving to raise tariffs to correct bilateral trade deficits with certain trade partners, as the new administration considers the phenomenon to be quite problematic.

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The intent behind the sequence of moves is to protect U.S. producers from their foreign competitors. Many warn that such protectionist tilt could plunge the world economy into chaos.

In the first place, why does a country's attempt to protect domestic producers from foreign competitors pose the risk of chaos? In this article, I would like to explain how protectionist trade policies could affect international trade and the world from an economic perspective.

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As a thought experiment, suppose that a country is shifting from free trade regime to a protectionist regime in which the government restricts trade by means of tariffs. Theoretically, this policy shift has the following three effects.

The first effect is to maintain domestic production. The imposition of import tariffs enables domestic producers to avoid fierce competition from their foreign producers. Thus, such measures have a positive impact on domestic producers.

The second effect is to enable the government to collect tariff revenue. Until its shift to a protectionist regime, the country had been imposing no tariffs on imports, thus collecting no tariff revenue. However, the imposition of tariffs will bring revenue to the government insofar as the country continues to import. Thus, the country benefits from restricting trade in the form of tariff revenue.

The third effect is to push up prices of products subject to tariff protection. The driving force behind the first effect of maintaining domestic production is higher prices resulting from tariffs, and consumers of such products will be the ones to face higher prices. As such, the imposition of tariffs has a negative impact on consumers.

In general, this negative impact on consumers more than offsets the combined positive impact of the first two effects on domestic producers and government revenue. Consider the case of the Japanese automotive industry as an example. It is a huge industry, and, when those working in related industries are included, an extremely large number of Japanese people are involved in the production and/or sales of automobiles. However, Japan has an even greater number of car users. Should the government impose tariffs on automobiles in an attempt to protect the domestic automotive industry, the amount of losses suffered by consumers in the form of higher prices will greatly exceed the combined amount of benefits gained by the domestic automotive industry and those derived in the form of tariff revenue. Thus, even if these benefits are to be entirely passed onto consumers, the net impact on Japan would be negative.

Furthermore, as companies expand their global value chains, one country's imports often include those exported by foreign subsidiaries of domestic companies, as exemplified by Japan's imports from China, which include various items manufactured by Japanese companies' subsidiaries in China. In such case, when a country imposes tariffs to restrict imports, it is also restricting the procurement of parts and finished products from the foreign subsidiaries of domestic companies and may end up having a negative impact on domestic producers.

This holds true not only for tariffs but also for other trade-distorting measures such as import quotas and export subsidies. For those reasons, protectionist trade policy is considered to be problematic.

Now, if the combined positive impact—i.e., benefits to domestic producers and tariff revenue—outweighs the negative impact on consumers, would this indicate that protectionist trade policy ceases to be problematic?

What we must not forget here is that when a country engages in international trade, there always is another country on the other side of the trade which may retaliate. When one country imposes high tariffs on imports from the other country and the latter retaliates by imposing high tariffs, prices of imported goods increase in both countries and trade will shrink. If they continue to raise tariffs, trade will shrink further.

Indeed, we all remember how trade friction developed into a devastating war in the past.

In the advent of the Great Depression in 1929, the United States took a hard line policy to raise tariffs significantly to protect competing domestic producers. As other countries followed suit, global trade contracted sharply and the global economic slump deepened further. The contraction of trade led to the fragmentation of the world economy into blocs, and a tariff war among the blocs eventually evolved into World War II.

There is a growing fear that the current trends toward protectionism may lead to the aggravation of international trade friction. This is one factor behind the ongoing confusion.

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Another important aspect of trade is that a country's trade deficit is not a trade issue. To simplify this, assume here that the trade balance is the same as the current account balance of payments. The balance of trade is the value of exports net of the value of imports. Meanwhile, from the expenditure side, gross domestic product (GDP) can be described with the following equation: *GDP = Consumption + Investment + Government expenditures + Exports - Imports.*

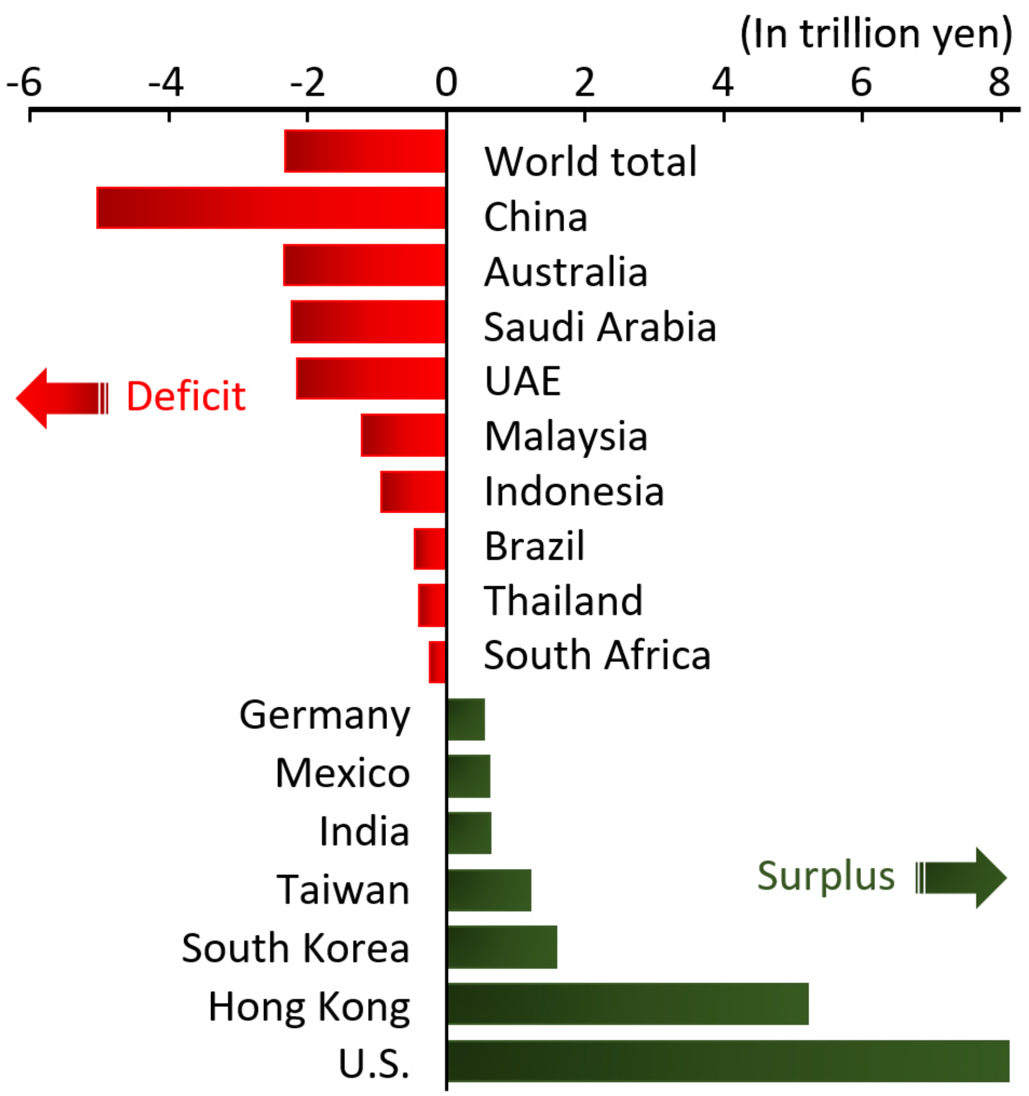
Now, if we focus on the fact that the income of an economy excluding taxes (i.e., disposable income) either is spent on consumption or saved, we can also describe GDP as: *GDP = Consumption + Savings + Taxes*. From these two equations, we can derive the following equation: *Consumption + Investment + Government expenditures + Exports - Imports = Consumption + Savings + Taxes*. This equation can be rewritten as: *Exports - Imports = (Savings - Investment) + (Taxes - Government expenditures)*.

This means that a country running a budget deficit with the government's expenditures exceeding its tax revenue, as has been the case of the United States in recent years, inevitably runs a trade deficit unless it has a savings surplus in an amount exceeding that of the budget deficit. Furthermore, since trade policy does not affect domestic savings and investment, it does not have any impact on trade balance, either. Accordingly, on a national level, a trade deficit is not a trade issue but is a problem of savings-investment imbalance including the government sector.

Likewise, even if one country continues to run a trade deficit with another country, such persistent bilateral trade deficit also is not a trade issue. As noted in the *Daiki Shoki* column on the January 21, 2017 issue of the *Nihon Keizai Shimbun*, it is only natural for one country to run a deficit or a surplus with the other in bilateral trade between a given pair of countries that differ in their industrial structure and the availability of natural resources.

The figure below shows Japan's balance of trade by country/region. We can see that Japan is running huge deficits with oil-producing countries in the Middle East. Being poor in natural resources, Japan has been importing natural resources and exporting manufactured products. Because of this pattern of trade, Japan tends to run deficits in its trade with resource-rich countries.

Figure: Japan's Trade Deficit by Country/Region (2015)



Note: The balance of trade includes the balance of trade in services.
Source: Ministry of Finance, "Balance of Payments (Regional Balance of Payments)"

Simply because of this fact, do we find Japan's trade with those resource-rich countries unfair? Are we going to demand oil-producing countries to import more products from Japan or restrict oil imports? The answer is "No." Seen from this perspective, it is obvious that a bilateral trade imbalance is not a trade issue.

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This year marks the 200th year since David Ricardo, a British economist, proposed the concept of comparative advantage, i.e., since the birth of the idea of comparative advantage. What would Ricardo say if he were to see the current trade restrictive trends? People often say that history repeats itself, but there are certain parts of history that must not be repeated.

Careful discussion must take place on the question of how we should redistribute benefits obtained from trade as well as on the adjustment costs associated with trade liberalization. However, we need to go back to the basic principle and renew our understanding that trade is not a zero sum game but instead is a positive sum game.

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*RIETI: http://www.rieti.go.jp/en/index.html

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