

European Community

News Release

BACKGROUND NOTE

EC- JAPAN RELATIONS -----

The European Community and Japan together produce about 40 per cent of the world's gross product and account for roughly 40 per cent of all international trade. Each has the United States as a major economic partner. Yet direct links between the EC and Japan, particularly in trade and other economic terms are disproportionately weak.

It is a priority of the European Community's external relations policy to strengthen the EC-Japan side of the EC-US-Japan triangle.

With 320 million customers, the EC is the free world's largest market. Japan's population is little more than one third that of the EC. The population of the United States is just over two thirds that of the EC. Yet Japan's trade with the United States is three times that of its trade with the EC. Of course, there are reasons of postwar history for this disparity. But these are no longer as valid as they may have been; and it is time for the triangle to become better balanced. In the Community's view, the strengthening of the EC-Japan link must be accompanied by a real, tangible impact on the striking imbalance in trade which has persisted and, in terms of a rising yen, has increased over the years.

The Community's structural trade deficit with Japan has continued to rise in ECU* terms, growing from 14 billion ECU in 1983 to 16.5 billion ECU in 1984 and an estimated 18 billion ECU in 1985. There

* 1 ECU = 1.39 CAD

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has also been a qualitative deterioration, that is to say, a decline in the value-added level of Community exports. The gap could widen still further as a result of a slowdown in US demand or the more marked rise in the yen against the dollar compared to its appreciation against European currencies.

But the Community's problem with Japan is not simply a matter of the persistent trade imbalance. A similar imbalance marks Japan's relations with most of its industrialized or industrializing trading partners. This is symptomatic of the deeper-rooted problem of the Japanese economy not being sufficiently integrated with the broader international economy.

In recent years Japan has amassed ever-larger current account surpluses, part of a heavily lopsided pattern at the broader international level. This continuing trend is giving rise to serious problems in monetary and trade equilibrium at world level. While Japan's external surplus is to some extent offset by the United States external deficit, it also reflects Japan's low level of manufactured imports and structural bias towards manufactured exports. This structure is characterized by strong ties within each of the large industrial groups operating in the major sectors of the economy and by a high degree of vertical integration; this has a strong impact on external trade and the domestic distribution system. The strategy pursued by Japan in its economic and commercial relations with the rest of the world - and from which it has had the greatest benefit - is largely based on this structure and now threatens to upset the whole international system of trade and finance, to the detriment not only of Japan's partners but also of Japan itself.

Japan already plays a significant part in international discussions of trade, currency, financial and development issues. It would now be appropriate for Japan to take on greater responsibilities in these fields.

Diversified relations with Japan on an equal footing might help to identify ways to correct the balance on the economic and trade front in a wider context. Conversely, more balanced economic and trade relations would remove causes of friction and make it easier to establish comprehensive and diversified ties. The very inter-relatedness of competitive strength, exchange rates, development, the opening up of markets to the free movement of goods and services and the growing international role of both the yen and the ECU all mean that the EC stands a better chance of developing a harmonious, balanced relationship along these lines.

In Japan itself a similar recognition prevails at the highest level - witness several speeches by Prime Minister Yasuhiro Nakasone during

the past 18 months. There is the same interest in improving the balance both of international economic relations and of the multilateral trade and payments system.

ECONOMIC BACKGROUND

Ever since Japan emerged as a power in international trade, its growth has been largely export-led, leading to the build-up over the years of surpluses on the external account. The surpluses are expected to go on increasing for the next two years. The latest OECD forecasts point to an increase in the overall current account surplus from the \$33 billion reached in 1984 and \$49.3 billion (actual) in 1985 to \$58 billion in 1986 and over \$62 billion in 1987, paralleled by the growth of the trade surplus.

Following the decisions taken by the Group of 5 on 23 September, 1985, the Bank of Japan intervened decisively, along with other central banks, to push the yen up against the dollar. In the long term a stronger yen should help bring down the trade and current account surpluses. In the last analysis, however, the impact on external balances of an appreciating currency depends on the economic policies which accompany it. It should also be borne in mind that the yen has gained mainly against the dollar and that its appreciation against European currencies has been modest.

Japan's current account surplus is partly due to a structural imbalance between domestic savings and investment. The huge savings surplus reflects weak domestic demand, caused in turn by the sluggish growth of household consumption, housing investment and public spending on social infrastructure, and by Japan's tax structure. Meanwhile, Japan has already changed from a traditional importer to an exporter of industrial technology, and the number of new national patents is on the increase.

While the marked rise in exports of manufactures has been constant (total : 12.6% of world exports in 1982), its imports of manufactures have not developed in the same way, but have for a number of years been stuck at around 2.4% of world imports of manufactures, as against 12% for the Community.

This imbalance is also illustrated by the following :

Percentage of imports of manufactures (GATT definition) in relation to 1984 gross domestic product :

EC :	6.2%
United States :	6.2%
Japan :	2.9%

Percentage of imports of manufactures in relation to total imports in 1984 :

EC :	46.1%
United States :	66.4%
Japan :	24.2%

Per capita value of imports of manufactures in 1984 :

EC :	US\$ 504
United States :	US\$ 949
Japan :	US\$ 271

(Concerning the EC, the figures refer only to the trade with the outside world and don't take into account commercial exchanges between EC member countries. If those were included, the per capita value of imports of manufactures would be more than double.)

In an attempt to raise the level of its imports, Japan introduced a series of market opening packages, culminating in the 3-year Action Programme announced in July 1985.

The Japanese authorities claim not to be able to gauge its impact on the actual increase in the volume of imports. They also claim that the effects on trade can only be small in the coming months. Despite the intention of the Japanese authorities to speed up implementation of the Action Programme, the judgement of the EC Council of Ministers last October that practical effects were likely to be limited and, in any case, slow to make themselves felt, remains valid.

The measures announced by Tokyo in October and late December to stimulate domestic demand will have only a marginal effect on the external imbalances. The official government forecast is that the October measures will boost total imports (no doubt including raw materials and semi-manufactures as well as manufactured goods) by \$2 billion in 1986. Japanese private-sector institutes, however, put the figure at less than \$1 billion. No figures have been advanced for the December measures. Prospects for a real import stimulus look poor in the short term.

POLITICAL AND STRUCTURAL FACTORS

However, there is also in Japan - particularly in the industrial and business community - a body of opinion either opposed to change, or simply tending to inertia or complacency. The roots of the problem within the system itself are not yet widely recognized, still less openly admitted by government and administration. There are still those in Tokyo who believe it will be enough for Japan to cut down visible barriers to trade and exhort businessmen to buy more foreign goods. They see no need for domestic policy

and structural changes.

It is said to be up to the overseas exporter to make the effort to increase sales to what, in their view, is the "free" Japanese market. Japan prides itself on having the "most open market in the world" - never mind the actual volume of imports. Others see a reduction of the surplus with the United States as the only real necessity.

Clearly there are limits to the ability of Japan's politicians to fulfill the expectations of international opinion unless they can rely on a sound, broadly-based national consensus reaching beyond government and administration to take in the parties, the main industrial and financial groups and public opinion as a whole. At present this seems a long way off.

THE EC VIEW

Maintaining a liberal system of world trade requires an improvement in the Community's relations with Japan wherever possible. It is hardly acceptable that Japan, as the world's third largest economy, and the Community, with a population of 320 million, representing over a fifth of total world production, should continue to be separated by trade, industrial and financial conflicts and not cooperate more closely on most international economic problems.

Comprehensive, diversified cooperation between the two sides is needed in order to find ways of achieving more harmonious world economic growth, establishing a more stable and predictable international monetary system, and preserving and strengthening the multilateral trading system. This bilateral relationship would form part of the wider cooperation between the three main "western" economic powers, the United States, the EC and Japan; in other words, relations between the two last-named powers must become as strong and sustained as those which each of them enjoys with the United States.

To this end Japan and the Community need to coordinate their economic policies more effectively. They should collaborate in developing the international role of the yen and the ECU as payment and reserve currencies. If the multilateral trading system is to be preserved and strengthened, Japan must take effective steps to bring its bilateral surpluses under control, and that means paying more attention to the yen's rate against European currencies. Clearly, too, closer economic links would be helped by greater two-way penetration in the form of investment projects or exchange of technology, given a propitious environment.

Cooperation is also needed in the search for solutions to international problems of mutual concern, such as development aid, on which Japan and the Community often, in fact, have rather similar views. It is the Commission's belief that such cooperation with Japan is in the interests of the Community.

The risk of trade conflicts, multilateral rather than bilateral, perhaps, may remain acute for some time, however, and could indeed increase over the next two years. Despite its huge surpluses, high growth rates, low unemployment and inflation and powerful manufacturing and technological base, Japan is still not playing an international role commensurate with its economic weight. The sense of responsibility and strong leadership evinced by the government in Tokyo have not done away with the multilateral structural imbalance which threatens the foundations of post-war cooperation and represents a veritable time-bomb within the trading system.

Alcoholic beverages - a test case

While Japan frequently claims that its market is among the most open in the world, in some sectors this is still far from the case. The Commission recently released a study (*) which demonstrates conclusively that the Japanese alcoholic beverages industry is heavily protected by a variety of fiscal and other mechanisms.

For wine, the protection is achieved mainly by imposing much (up to 8 times) heavier duties on bottled wine than on bulk wine, thus giving Japanese bottlers access to cheap raw materials. High quality wines are further penalized by an ad valorem tax.

For whisky, brandy and cognac, the protection results from the very heavy tax rates imposed on the imported products. In the case of whisky, for example, the system is as follows : Japan defines 3 grades of "whisky", special, first and second. The tax on "special" is twice that on "first" and seven times that on "second". All Scotch and Irish whiskies are automatically classified as "special grade" and so pay the heaviest tax rate. Indeed the 1st and 2nd grade "whiskies" made in Japan would not be recognized as whisky elsewhere in the developed world. The tax and classification system for brandy and cognac is similar. In each case, the protection is reinforced by heavy customs duties which,

(*) "Study on EC wines and liquor exports to Japan", available in English and Japanese from the EC Delegation in Tokyo.

even after the Action Programme cuts, remain much higher than the EC duty rates.

The Community has called on Japan to reform this system. A first round of talks was held in April in which detailed proposals were put forward. The Community hopes that the Japanese authorities will take rapid action which will have an immediate and positive impact on the flow of imports of wines and liquor into Japan. Removing the tax and duty barriers will enable European products, which are of high quality, to compete under fair and open conditions. This reform could be achieved without any loss of revenue for the government of Japan, simply by redistributing the fiscal burden fairly.

The Council of Minister's Declaration

In February this year, the President of the EC Commission, Mr. Jacques Delors, stressed during an official visit to Japan that (a) Japan's imports of manufactured goods and processed food are comparatively inadequate to maintain the world multilateral trading system, that (b) Japan should expand domestic demand and that (c) Japan should continue to liberalize its financial and capital markets. He emphasized the need for closer cooperation with Japan and agreed with Prime Minister Nakasone on setting up a special monitoring system to be led by one official on each side responsible directly to Mr. Delors and to Mr. Nakasone.

Following Mr. Delors' visit, the EC Commission sent a report (COM(86)60) to the Council analyzing the EC's relations with Japan and making recommendations. After discussions in February and March, the Council endorsed the Commission's views. It issued a statement which, inter alia, warned that no new concessions will be made to Japan in the forthcoming New Round of multilateral negotiations under the GATT without a fundamental change in Japan's reluctance to import manufactured goods and processed agricultural products.

The Council considers it highly important that Japan should :

- indicate when a significant increase of manufactured goods and processed agricultural products imports into Japan can be expected; such an indication would increase Japan's credibility vis-à-vis its trading partners;
- take further early steps, to stimulate domestic demand effectively;
- avoid measures which could weaken the effect on the trade imbalance of the recent efforts to strengthen the yen and stimulate internal demand;
- speed up the liberalization of Japanese financial markets; and

- introduce the structural reforms enabling the Japanese economy to become more integrated with the economies of its partners.

The EC Council strongly supported the Commission's intentions to :

- arrange with the Japanese government regular and detailed joint monitoring of the Japanese Action Programme and other market opening measures;
- keep up pressure on Japan for a greater and more effective liberalization, against firm deadlines, of Japanese markets (visible obstacles, non-tariff measures, standards and certification procedures and terms for investment in Japan) particularly in certain specific sectors such as the alcoholic beverages sector;
- keep constantly under review the redress available to the Community in GATT to combat unfair trade, including anti-dumping actions, and to study thoroughly the practical use of GATT Article XXIII.2;
- press the Japanese government to mitigate the effects of the trade imbalance by increasing multilateral untied aid.

The Council underlines the necessity to re-establish a true balance of advantage between Japan and the Community. In particular, it noted that, in the context of the GATT, and in the context of the New Round of multilateral negotiations and its preparation, the present imbalance of real advantages between Japan and its partners will have to be dealt with. For Japan to be able to benefit from further concessions from the Community which would be substantially to its advantage will require a fundamental change in Japan's reluctance to import manufactured and processed agricultural products.

The Council took note of the Commission's proposals for strengthening the dialogue in a number of areas such as science and technology, industrial cooperation, economic and financial policy, monetary questions and North-South issues, including the debt problem.

Throughout its analysis the Commission seeks a more constructive and cooperative relationship with Japan, calling upon the Community itself to multiply its efforts; in particular it proposes measures during the next two years to double activities aimed at language training and backup for small and medium-size firms on the Japanese market.

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