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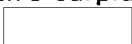
The US-Japan Trade Imbalance: Even Larger in 1986



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Summary

The 55-percent appreciation of the yen relative to the dollar since last September has not yet dented the massive imbalance in trade between Japan and the United States. Tokyo apparently expects the announcement of another record surplus to generate increased trade tension, although we see no signs of a Japanese strategy to head off new trade restrictions. Based on data for the first seven months of 1986, supplemented by projections from the CIA's econometric model of Japan, we believe that Japan's surplus will be at least \$10 billion higher than 1985's record level.



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Most of the increase in Japan's trade surplus with the United States is occurring because US importers, at least for a time, continued to import about the same quantity of Japanese products, even though the dollar prices of these exports rose sharply following the yen appreciation that began about a year ago. The sluggishness of the Japanese economy in the first half of the year also reduced Japanese imports from the United

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This memorandum was prepared by [redacted] Office of East Asian Analysis, and with a contribution from [redacted] Office of Information Resources. Information available as of 19 August 1986 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Japan Branch, Northeast Asia Division, OEA, [redacted]

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States, widening the trade imbalance. A further strengthening of the yen or an acceleration in US economic growth compared with growth in Japan this fall could add another \$5 billion to the trade imbalance in 1986. [Redacted]

[Redacted]

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The Ballooning Deficit

Japan's large trade surplus with the United States is getting worse. In the first seven months of this year, the surplus totalled \$27.5 billion--a third higher than the same period last year.¹ The value of Japanese exports to the United States grew by 25 percent with increases registered in every major product category except iron and steel. At the same time, Japanese imports from the United States showed only a marginal increase. [Redacted]

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The United States is not the only country to feel the impact of the recent Japanese trade expansion. Indeed, the US share accounted for only 60 percent of Japan's overall trade surplus of \$46.3 billion in the first seven months of 1986, compared with 70 percent of the total for the same period last year. This drop largely reflects the rapid Japanese gains in exports to the EC market--particularly in electronic products and automobiles--as well as the sharp decline in oil prices which should reduce the value of Japan's oil imports by some \$15 billion in 1986. The decline in oil imports, in fact, will probably leave Tokyo with a small trade surplus with developing countries this year, compared with an \$11 billion deficit in 1985. [Redacted]

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Factors Behind the Runup

In our view, the rapid increase in the US-Japan trade imbalance during the first half of 1986 results primarily from the higher dollar prices of Japanese exports and the slow response of export volume to yen appreciation--the so-called J-curve effect. Export volumes have declined only 2 percent so far this year compared with their levels a year ago. Slow economic growth in Japan compared with the US economy has also added to the trade deficit. [Redacted]

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The J-curve effect. As the yen appreciated against the US dollar in late 1985 and early this year, the dollar price of Japan's exports increased rapidly. Japanese exporters with contracts denominated in yen--about 40 percent of Japan's total export contracts [Redacted]--received more dollars for approximately the same volume of overseas shipments. Export volumes generally react slowly to a price increase. In the Japanese case, according to our econometric model of Japan, only 40 percent of the volume response occurs in the first two quarters after a price increase. Initially, therefore, following the yen appreciation of 1985-86, the dollar value

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¹ Our bilateral trade numbers are based on Japanese trade statistics which differ from those calculated by the US Commerce Department. In 1985, the trade deficit by US standards was roughly \$10 billion larger than the deficit by Japanese standards, on the customs clearance basis. [Redacted]

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of Japan's exports increased sharply. Our estimates indicate the J-curve effect increased Japan's surplus with the United States by nearly \$10 billion in the first half of this year. [Redacted]

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The J-curve effect--and thus the widening of the trade surplus--would have been even more pronounced if Japanese firms had not moved to cut costs and trim their yen prices to maintain market share abroad. [Redacted]

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[Redacted] Japanese companies have on average lowered their yen export prices by 15 percent since the yen began appreciating last summer. [Redacted]

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[Redacted] firms have trimmed their production costs by importing components from lower wage countries--such as South Korea, Taiwan, and Singapore--as well as by reducing payments to Japanese subcontractors. The short-term effect of this strategy has been to hold down the dollar price of exports and therefore--given the relatively constant US demand for Japanese products--to limit the increase in Japan's surplus. According to our estimates, if Japanese firms had maintained their yen prices and therefore raised dollar prices by the full amount of the appreciation, the US-Japan trade imbalance would have risen another \$6 billion higher over its levels for the first half of 1986. In the longer run, if the Japanese hold prices down, it will mitigate the tendency of the appreciation to lower demand for Japan's exports. [Redacted]

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Economic Growth in Japan and the United States. Japanese output fell in the first quarter of this year, contracting at a 2.1 percent annual rate--the first quarterly drop in 11 years--and the slowdown will probably last for the rest of the year. The yen appreciation has trimmed export volumes, reducing profit margins and forcing cutbacks in spending on industrial equipment. From the perspective of the US-Japan trade imbalance, the slowdown in growth--by holding down Japanese imports--has helped to expand the bilateral trade surplus. Our econometric model suggests that for each one percentage point decline in Japanese growth, Japan's trade surplus with the United States increases approximately \$3 billion. [Redacted]

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Outlook for 1986

We believe the growth in the bilateral trade imbalance will slow somewhat in the remainder of the year, with Japan's 1986 trade surplus approaching \$50 billion (approximately \$60 billion by US standards). This is \$10 billion more than last year's record. An expected decrease in Japanese export volume largely accounts for the slower growth in the surplus. By yearend 1986, two-thirds of the downturn in export volume stemming from the price increases early this year will have occurred. We base our judgment on the swing in export volume in part on the recent sharp reduction in signed export contracts--particularly for machinery orders. Such contracts now have declined for five consecutive months and we expect the impact on export volumes to start appearing soon. [Redacted]

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Alternative Outcomes

Our projection of the US-Japan trade imbalance assumes that the yen-dollar exchange rate remains fairly stable at 155 yen to the dollar for the remainder of the year. The yen could appreciate further--a development that would again increase the dollar price of Japan's exports and further widen the trade imbalance. If the yen strengthens to 130 to the dollar by the end of the year, our model suggests the J-curve effect would push the US-Japan trade imbalance to \$58 billion--\$8 billion higher than our current baseline estimate. [Redacted]

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A change in Japanese or US growth would influence the trade balance to a lesser extent. If the US economy grows more rapidly--as some economists are now predicting--Japan's trade surplus with the United States would increase as US consumers and firms expand their purchases. Faster growth in the US economy--enough to raise US output in 1986 by an additional percentage point over the baseline--would raise the surplus by almost \$1 billion, according to our model. We caution, however, that the model may underestimate the effect of US growth because the model fails to take account of the impact of US growth on the rest of world and the consequent additional increase in Japanese exports. Thus, if US growth does accelerate, Japan's surplus could even be higher. Indeed, some US banks are projecting that the bilateral trade surplus could reach nearly \$70 billion this year, although their assumptions about exchange rates and growth are not clear. [Redacted]

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The View From Tokyo

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Past experience would suggest that the Japanese expect US press attention and political criticism to renew when the extent of the trade imbalance becomes clear.

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[Redacted] We believe the Japanese Government will remain in its traditional reactive mode--waiting for the United States or other trading partners to threaten additional trade restrictions--before taking any politically difficult steps to narrow the trade imbalance. [Redacted]

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If US legislative action or other pressures arise, Tokyo will quickly develop a strategy to deal with increased "protectionist threats." Under current conditions, a

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possible Japanese tack would be to point out that the expanding trade balance is a short-term phenomenon and will erode over time because of the yen appreciation.

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Figure 1

Japan: Trade with the United States

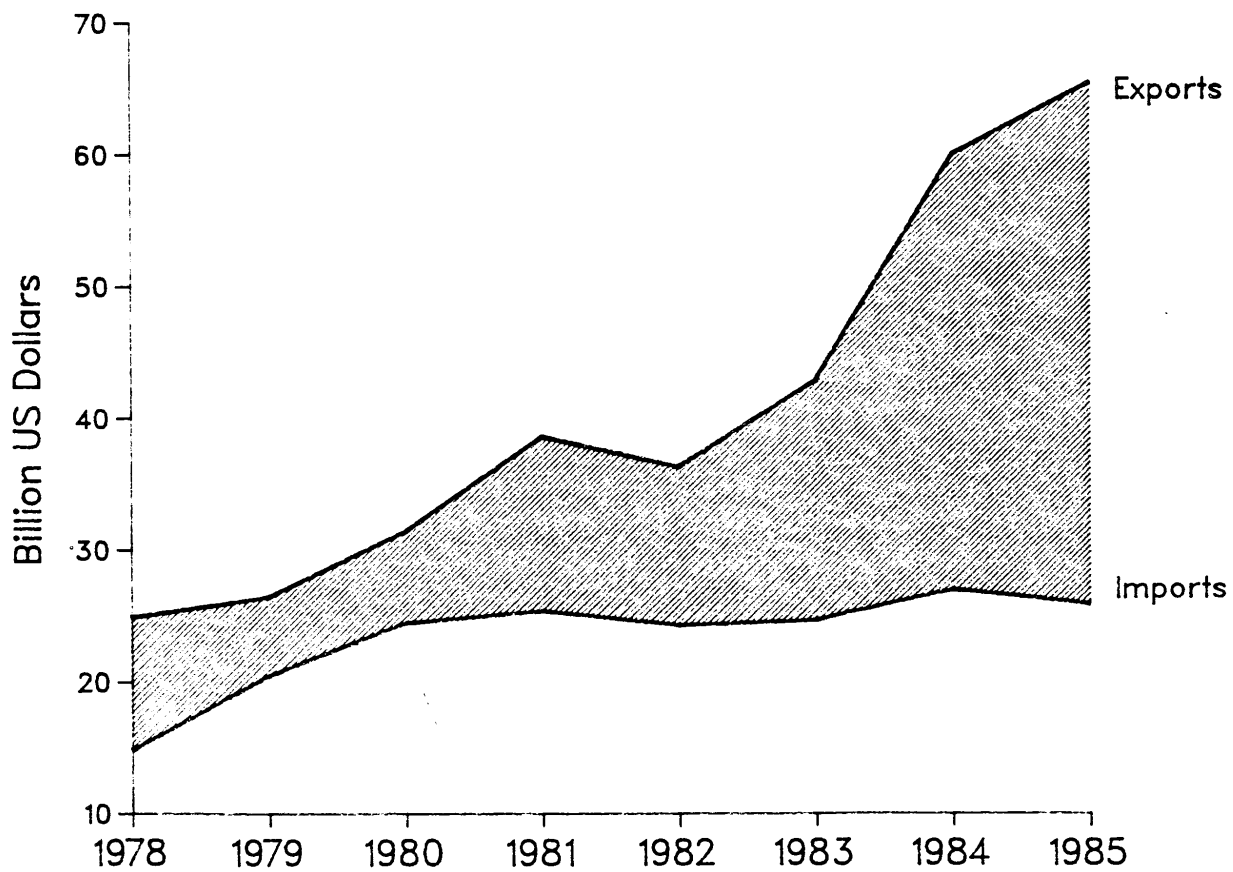
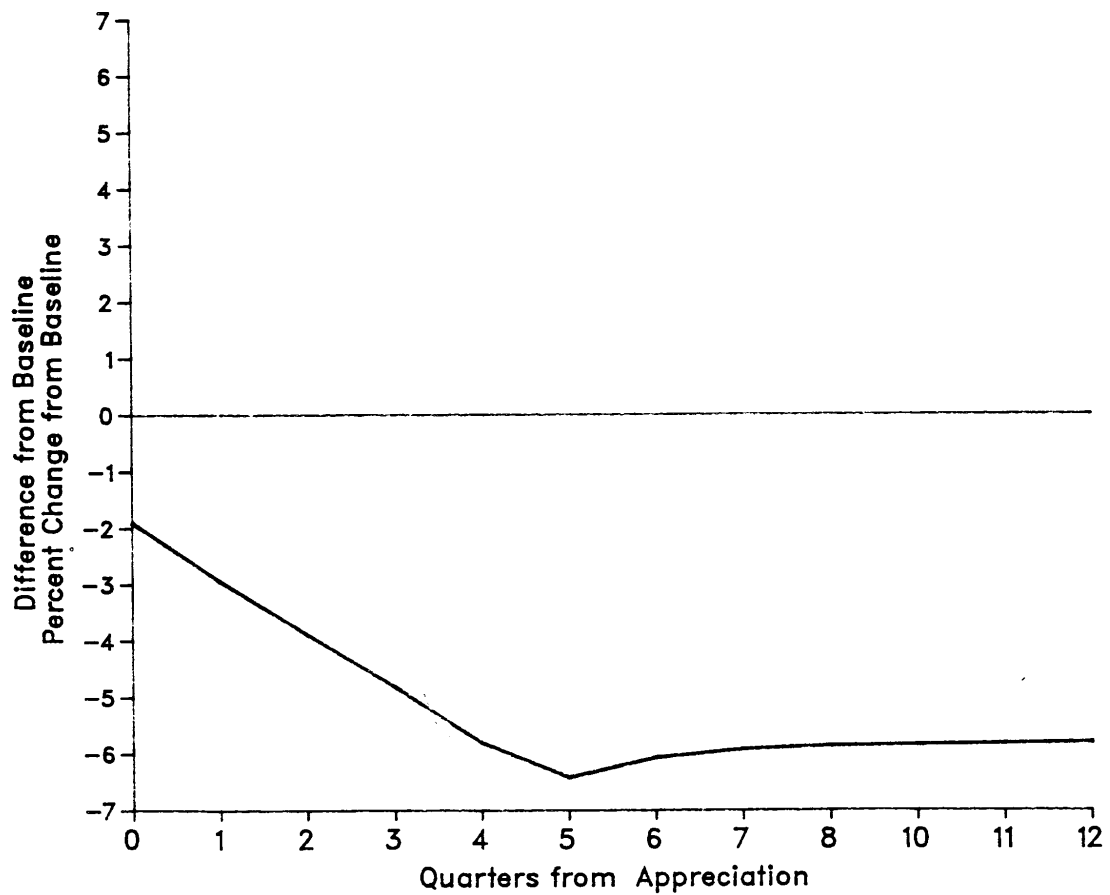


Figure 2

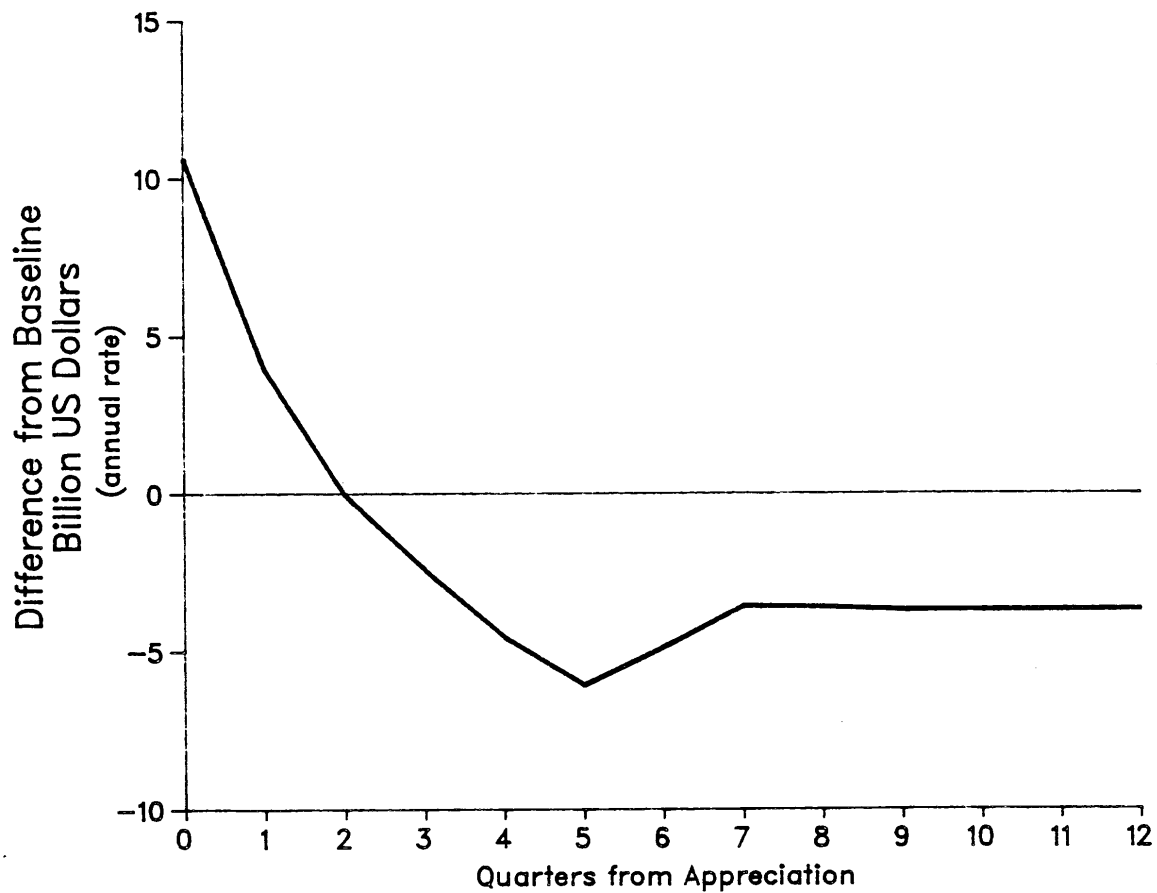
Japan: Export Volume Response to 10 Percent Yen Appreciation*



*Based on our econometric model of Japan.

Figure 3

Japan: Effect on Trade Surplus of 10 Percent Yen Appreciation*



*Based on our econometric model of Japan.

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Title: The US-Japan Trade Imbalance:
Even Larger in 1986 [Redacted]

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