

TRADE AND
INVESTMENT
RELATIONS
AMONG THE
UNITED STATES,
CANADA,
AND JAPAN

Edited by ROBERT M. STERN

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ROBERT M. STERN is professor of economics at the University of Michigan at Ann Arbor. Currently, he is visiting professor of economics at Brandeis University.

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Preface

This book contains the papers and discussants' comments that were prepared in connection with a conference on U.S.-Canadian trade and investment relations with Japan that was held at The University of Michigan on April 2–3, 1987. The convening of this conference was motivated by the very close economic ties that characterize the relations among these three nations and the evident need to understand the structural determinants and policies that shape these relations. All too often, the public debate seems to focus primarily on short-term issues and policy solutions. Our objective at the conference was to bypass the preoccupation with events and policies of the moment and to concentrate instead on the underlying theoretical and empirical fundamentals involved. It is our hope, therefore, that the papers and comments that constitute this book will serve to inform the public debate on the important issues and provide the basis for a dispassionate evaluation of the current and prospective policies that are designed to affect the economic relations among the three nations.

The planning and organization of the conference represent the joint efforts of Robert M. Stern, Gary R. Saxonhouse, John Whalley, and the associated staff members of the Institute of Public Policy Studies (IPPS), the Japan Economy Program of The University of Michigan, and the Centre for the Study of International Economic Relations of the University of Western Ontario. We would especially like to thank Judith Brown and Judith Jackson of IPPS and Irita Grierson of the Japan Economy Program for their assistance in organizing the conference and taking care that everything ran smoothly. Judith Jackson is also to be thanked for her assistance in typing and revising the conference papers and comments and preparing the final manuscript. Finally, Filip Abraham is to be thanked for providing critical comments and editorial assistance on several of the papers.

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1 Introduction Robert M. Stern

The decade of the 1980s has been marked by unprecedented macroeconomic imbalances between the United States and the other major industrialized countries. The source of the imbalances seems to stem primarily from the U.S. macroeconomic policy mix that was implemented by the Reagan administration beginning in 1981 and involved highly expansionary fiscal policies together with relatively tight monetary policies. This combination of policies served to increase U.S. aggregate expenditure. The fiscal stimulus was provided by substantial reductions in personal and corporate income taxes, and given that it proved difficult to effect major reductions in government expenditures, it is not surprising that sizable budget deficits emerged.

In a closed economy, the effects of these policies would be to crowd out private spending and, if the fiscal expansion were to be financed in a noninflationary manner, domestic savings would need to rise to accommodate the increased budget deficit. In an open economy with internationally mobile capital, however, the policies may induce a capital inflow from abroad, so that foreign savings could in effect serve to finance some part of the government budget deficit. In these circumstances, the inflow of capital would create an excess demand for the country's currency and, under floating exchange rates, the currency would appreciate. The counterpart of the capital inflow and currency appreciation would be a deficit on current account as imports of goods and services increased and exports declined. The foregoing scenario seems broadly descriptive of what occurred in the U.S economy between 1981 and 1985. In particular, the expansionary fiscal policy appears to have crowded out the foreign sector since expenditure and output increased substantially elsewhere in the economy and, in the aggregate, the economy moved toward essentially full employment following the 1981-82 recession.

Japan's experience is the mirror image of what took place in the United States. That is, beginning in the early 1980s, especially in the wake of the financial liberalization that was occurring in Japan, there was a sizable capital

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outflow as Japanese savings were increasingly directed to investment in various kinds of official and private assets in U.S. financial markets. The Japanese current account in turn moved into surplus to accommodate the capital outflow, and a very sizable proportion of the current account surplus had its counterpart in the U.S. current account deficit already mentioned.

As a result of the difficulties that U.S. import-competing and export firms were experiencing because of the dollar appreciation, considerable pressure was brought to bear on the Congress to take measures to improve the situation of different industries. It was inevitable in the circumstances that Japan was subjected to sharp criticism because of the substantial trade surpluses that it was experiencing vis-à-vis the United States. The Japanese were also criticized at times for saving too much. What is especially interesting is that there was little recognition and acknowledgment in all of this of the impact that U.S. macroeconomic policies were having domestically and abroad. A continuing air of tension and crisis has thus marked U.S.-Japanese economic relations during the 1980s.

When one considers U.S.-Canadian relations, there has been a remarkable calm in comparison to U.S. relations with Japan. This is the case even though Canada is the single largest trading partner of the United States and accounts for a substantial proportion of U.S. foreign direct investments. Further, even though Canada was also experiencing a sizable trade surplus visarvis the United States, it was not singled out for criticism in the same way as Japan. It is of interest to note that Canada's macroeconomic situation has paralleled that in the United States, with sizable government budget deficits both in absolute terms and as a percentage of gross national product. In the United States, as was noted above, foreign savings were instrumental in helping to finance the U.S. budget deficit. In Canada, in contrast, domestic savings have increased substantially enough to finance the budget deficit. Thus, deficits and foreign capital inflows are not inevitable, so the U.S. experience appears to be unique.

While the United States accounts for a predominant share of Canada's exports and imports, Japan is an important trading partner for Canada as well. The Japanese market provides a major outlet for Canadian exports of agricultural foodstuffs and raw materials. Since Japanese import restrictions are severe for a number of primary products, Canada and the United States have a common interest in inducing the Japanese to reduce or remove these restrictions. Canada is a significant importer of a variety of manufactured goods, including vehicles, from Japan. Canada may, therefore, experience some of the same competitive pressures from Japanese imports as the United States. In the automobile industry in particular, Canada has followed the U.S. lead in negotiating a voluntary export restraint (VER) agreement limiting imports of automobiles from Japan.

In the winter of 1985, the appreciation of the U.S. dollar reached its peak and since then the dollar has depreciated substantially, especially against the Japanese yen and the German mark, and to a lesser extent against other major currencies. The reasons for the onset of dollar depreciation are not entirely clear. But it appears that the combined effects of the passing of the Gramm-Rudman-Hollings deficit reduction legislation and an easing of U.S. monetary policy may have altered expectations about future interest rates and the exchange rate, and thus reversed the appreciation that had occurred in the previous five years.

Under ordinary circumstances, it would be expected that dollar depreciation would bring about a reduction in the U.S. trade and current account deficit. While this has in fact occurred, many observers have been surprised with how long it has taken for the external deficit to decline. Here again, the explanations are by no means clear. It may be the case that the macroeconomic forces behind the budget and current account deficits are still sufficiently strong such that any sizable reduction in the current account deficit will be constrained. Also, it appears that the U.S. economy has continued to expand significantly in 1986–88 relative to its major trading partners, so that imports have not declined as much as might have been expected. Finally, some foreign exporters may have opted to absorb a substantial proportion of the exchange rate changes by reducing their profit margins in an effort to retain their market shares in the United States, while other foreign exporters in countries with currencies pegged to the U.S. dollar have been able to increase their exports to the United States.

Whatever the explanation may be, because the nominal U.S. external deficit has not been materially reduced, the pressures on the U.S. Congress to implement restrictive trade actions have not abated. Whether this state of affairs will continue is difficult to determine. It may be that the sudden decline in equity prices that occurred in the United States and other financial centers in October 1987 will provide the impetus to take more effective measures to reduce the existing macroeconomic imbalances among the major industrialized countries, and that the external imbalances will be correspondingly mitigated. Also, implementation of the U.S.-Canadian Free Trade Agreement and progress in the ongoing Uruguay Round of multilateral trade negotiations may serve to diffuse a variety of trade policy irritants between the United States and its two major trading partners. Only time will tell.

1.1 Pertinent Insights and Conclusions of the Conference Papers and Comments

The conference papers and comments that follow address many of the foregoing issues in depth. Each session in the conference involved authors and

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discussants from the United States, Canada, and Japan. While an effort was made to have the authors focus their papers on issues common to the three countries, this was not altogether feasible. The discussants' comments may thus provide a national perspective that supplements the individual papers.

In anticipation of what is to follow, some readers might find it useful to have an idea of some of the pertinent insights and conclusions that the authors and discussants offer in their respective contributions and that cut across a number of the contributions. These are:

- 1. While the simple life-cycle model is useful in understanding saving behavior, it cannot fully explain intercountry variations in private saving rates. It is necessary to take into account such factors as differences in the rates of economic growth, differences in institutions and cultural determinants of behavior, tax incentives, and demographic characteristics in trying to explain why private saving rates are higher in Canada and especially in Japan, compared to the United States.
- 2. In the coming decades, it is possible that Japan and Canada will continue to expand and converge on U.S. efficiency levels and per capita income. The same may be true for the newly industrializing East Asian economies. Private saving rates in Japan may be sustained at relatively high levels, although demographic changes may necessitate higher taxes to support an aging population.
- 3. The yen/U.S. dollar exchange rate has been considerably more volatile than the Canadian/U.S. dollar rate. The yen volatility may be explained in part by the deregulation and internationalization of financial markets and the resulting substantial increase in international capital mobility in Japan. The comparative stability of the Canadian dollar may reflect the close integration of the Canadian and U.S. economies and the exchange market intervention of the Bank of Canada. In designing an empirical framework to investigate the sources of exchange rate volatility, it is important to take into account the different types of shocks to which the exchange rate is subject, the problems of collinearity in the returns on domestic and foreign assets, the stability of the demand for money, central bank intervention in the exchange markets, the effects of innovations in financial markets, and the consequences of uncertainty in the design and implementation of macroeconomic policies.
- 4. Divergent fiscal policies have been the major sources of the macro-economic imbalances between the United States and the other major industrialized countries in the 1980s. The empirical modeling of the determinants of these imbalances, future predictions, and recommendations for policy call for careful consideration of the underlying national policies and institutions, the global linkages, and the relevant parameters to describe the behavior of the important transactors and policymaking authorities.
- 5. The increases in Japan's exports of manufactures have been concentrated in automobiles, office machinery, telecommunications equipment, and

electric machinery. While Japan has been criticized for having relatively small imports of manufactured goods, there is evidence that this is changing dramatically, particularly in response to the appreciation of the yen. The use of VERs by the United States and Canada to limit imports of manufactures from Japan may be undermined by product upgrading, shifts to other sources of supply, and competition from Japanese firms that have expanded production by means of direct investment in importing countries.

- 6. Japan has very substantial barriers limiting the importation of agricultural foodstuffs and materials. Reductions in these barriers would be beneficial both to the United States and Canada, but attention must be given to policies that would ease the process of adjustment in the agricultural sector in Japan. U.S. domestic agricultural policies may be highly detrimental to Canada and other major agricultural exporters because they may result in lower world prices. U.S. export subsidies may displace competing suppliers and, furthermore, result in sizable income transfers to importing countries.
- 7. Industrial policies to aid declining manufacturing industries are often motivated more by political than economic considerations, and the policies differ noticeably among countries. Trade policies have been the most prevalent form of assistance to industries in the United States and to a lesser extent in Canada, whereas in Japan a wider range of policies has been used in apparent recognition of differences in industry characteristics and adjustment needs. Japan has outperformed both the United States and Canada in productivity improvements in declining sectors, but it is not obvious that Japan's experiences are readily transferable to other countries. In the United States and Canada, it may be necessary to take a much longer view of adjustment problems and policies, and to contemplate longer-term policy options that may be more costly than the shorter-term policies currently being used.
- 8. Existing taxes and proposed tax reforms have a variety of effects on international trade and investment flows. The most important effects stem from fiscal deficit imbalances and the overall impact of a nation's tax structure. The effects of indirect and trade taxes are of lesser importance in the aggregate, but may have sectoral importance.
- 9. Economic growth and development in the nations constituting the Pacific region have been marked by a dynamism resulting from the outward-looking and liberal policies adopted in the major countries there. The continuation of this dynamism will be assisted by intergovernmental cooperation to maintain open markets and expand international financial flows. In view of its very sizable current account surplus, Japan should be encouraged to assume a position of leadership in the region and to promote large-scale transfers of capital to developing countries, thus reducing some of Japan's financial flows to the United States.
- 10. Access to markets in importing countries may be affected by cultural factors that stem from the characteristics of a nation's social network.

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social custom, and the reputation of domestic firms. Policies of administered protection and the strategic behavior of imperfectly competitive firms may also serve to limit market access. In the case of Japan, certain business practices that appear to be restrictive may in fact reflect rational behavior in designing long-term contracts and maintaining long-term relations between firms and consumers.

11. The empirical evidence relating to formal trade barriers suggests that Japan's tariffs and nontariff barriers are relatively low overall and comparable to those maintained by the United States and Canada. When both formal and informal barriers are taken into account, the empirical evidence also suggests that Japan's trade barriers are not distinctive in comparison to the United States, Canada, and other major trading countries. Japan's trade performance can thus be explained in terms of its national factor endowments and distance from markets, rather than by its trade policies.

1.2 Brief Summaries of Conference Papers and Comments

1.2.1 Helliwell: "Some Comparative Macroeconomics of the United States, Japan, and Canada"

Helliwell begins by reviewing the alternative approaches to the modeling of the balance of payments and the macroeconomic linkages among nations in order to provide a framework in which to examine the behavior and possible future evolution of the important macroeconomic aggregates of the United States, Japan, and Canada. He shows that the private saving rate—which includes both household and corporate savings—is substantially higher in Japan than in the United States, and that the Canadian rate has risen since the 1970s nearly to the level of the Japanese rate. In order to explain saving behavior, one can rely on the simple life-cycle model. But, as Helliwell notes. although the model may identify the reasons for international differences in saving rates, its parameters may not be robust in forecasting the future evolution of saving rates for the three nations. Helliwell also notes that the model is limited insofar as it does not take into account such factors as liquidity constraints and the diversity of motives and circumstances characterizing the actual behavior of households. He mentions several additional factors that may explain intercountry differences in private saving rates, including: the tax treatment of consumer borrowing, availability of consumer credit, tax treatment of interest income and private savings for retirement, differential rates of inflation, increases in life expectancy, differences in the role and structure of the family, the work ethic, the Japanese bonus system, and differences in female labor force participation rates.

In presenting evidence on government saving rates, Helliwell notes that

net government savings have become significantly negative in both Canada and the United States since 1980, but have remained positive and fairly stable in Japan since 1975. The growing fiscal deficits in Canada are largely attributable to rising transfer payments and falling revenues, while the U.S. fiscal deficits stem from growing current spending and falling taxes. The evidence on net foreign saving rates is that there has been a net outflow of capital from Japan amounting to over 3 percent of GNP by the mid-1980s. Canada has been a net capital importer for the most part. The United States had a relatively small rate of net capital outflow/inflow until the early 1980s, but net capital imports rose to 3 percent of GNP by the mid-1980s, mirroring the experience of Japan. While there are several different views of the forces determining net capital movements, a currently popular view stresses the importance of high international capital mobility combined with the absence of tightly integrated international markets for physical capital and lack of effective arbitrage between equity and debt markets within countries.

It is especially noteworthy, according to Helliwell, that Japan has had higher and more stable rates of growth of per capita output and income than either the United States or Canada. These higher rates of growth have facilitated or caused the much higher rate of Japanese private saving and may themselves be partially caused by the much higher Japanese rate of investment. To help understand the links between investment and the growth of output, Helliwell develops a factor-utilization model of production. In this model, technical progress is treated according to whether the rate of technical efficiency is constant or whether there is a process of catch-up or convergence among the countries. The constant-efficiency-growth model is nested within the general-convergence model. Helliwell's empirical results clearly favor the convergence model. It is thus suggested that Canadian and Japanese efficiency levels are approaching U.S. levels, and in time would even exceed U.S. levels if higher capital stock growth is maintained in the two countries. He also presents results for the behavior of output and employment in the three countries.

In reflecting on the empirical evidence presented, Helliwell stresses the need for a quantitative model that would capture the important macroeconomic linkages both within and between countries. While some models do exist, they do not adequately portray the supply-side structures of the national economies or capture longer-term trends. Nonetheless, these models suggest that fiscal contraction in the United States would have an important impact in reducing the U.S. current account deficit over a period of years. However, fiscal expansion abroad does not have symmetrical effects on the U.S. current account deficit because of offsetting changes in exchange rates.

In considering the likely future evolution of savings, investment, and external balances in the three countries, Helliwell offers the following tentative conclusions:

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1. The rate of productivity growth and the saving rate in Japan will converge on the rates in the United States and Canada.

- 2. Changes in the tax treatment of interest expense and interest income will tend to raise saving rates in the United States and lower them in Japan.
- It may well be that Japan's characteristically high rates of saving and investment will be emulated by other countries, but that Japan will continue to have saving rates well above the average of comparable high-income countries.
- Public and private saving rates in Japan are likely to be sustained to
 provide for the retirement incomes of older persons in the first quarter
 of the new century.
- 5. Japanese capital markets will continue to be internationally integrated, resulting in greater equality in interest rates on similar types of assets. There may also possibly be greater equality in returns on equities because of the increasing internationalization of business.
- The convergence of growth rates in the United States, Japan, and Canada may be below the world average as the locus of economic activity and international real capital shifts to the emerging industrializing countries.

In his comment on Helliwell's paper, McKinnon notes that the sudden emergence of large U.S. trade deficits and Japanese surpluses in the mid-1980s is attributable to the increase in the structural U.S. fiscal deficit rather than to long-term trends in saving and investment behavior. It is interesting that, in Canada, a large fiscal deficit did not result in a current account deficit because there was a large increase in Canadian private savings. McKinnon attributes this increase to the more generous treatment of individual retirement plans in Canada beginning in the mid-1970s. He also considers the question of whether exchange rate changes are important in the process of transferring capital between countries. He argues that international transfers of capital are better expedited without nominal changes in exchange rates, noting the experience of the U.S. dollar appreciation in the early 1980s and the subsequent depreciation in 1986–87.

In his comment, Fukao stresses the aging of the Japanese population and its interaction with the government sector via the pension system. He notes that the percentage of the population in Japan over 65 years of age will increase from 10 percent in 1985 to an estimated 22 percent by 2020. This in turn may result in a significant increase in the tax rate on employee income and a decline in savings. He also maintains that the surplus in the Japanese government's social security fund will be substantially reduced in the future. He is, therefore, much less sanguine than Helliwell about the continuation of

relatively high saving rates in Japan. Fukao calls further attention to the international crowding-out effects of high real interest rates, as investment is affected by changes in the real cost of capital and there is accompanying international movement of capital.

1.2.2 Sazanami: "Trade and Investment Patterns and Barriers in the United States, Canada, and Japan"

Sazanami notes that Japan's trade with the United States accounted for over two thirds of its \$56 billion global trade surplus in 1985, and Japan's capital outflows have been increasingly directed toward the United States. Japan's trade with Canada was roughly in balance in 1985. Between 1980 and 1985, Japan's imports from the United States increased by only \$1.5 billion, while Japanese exports to the United States rose by \$34.4 billion. Thus, the U.S. share in Japan's total exports increased from 24 percent in 1980 to 38 percent in 1985. Japan's increased exports to the United States were concentrated in automobiles, office machinery, telecommunications equipment, and electrical machinery. This same pattern of change was evidenced as well in Japan's exports to Canada. On the import side, there was a shift in Japan away from resource intensive products, which adversely affected both the United States and Canada.

The increase in U.S. imports from Japan has led to increasing friction between the two nations, with the United States instituting restrictive import measures involving such products as color televisions, automobiles, and iron and steel products in the late 1970s and early 1980s. For its part, Japan has introduced a number of measures to improve foreign access to its markets in a number of sectors. They took these steps even though there is no clear evidence, except for agricultural and food products, that Japanese tariffs and nontariff barriers are unusually high relative to the other major industrialized countries. While it is difficult to assess the impact of Japan's market-opening measures, there has been a noticeable increase in recent years in the share of manufactured goods in total imports. Some of this increase may be attributable as well to the sharp appreciation of the yen since the winter of 1985. While the U.S. restrictions apparently reduced imports of color TVs from Japan, there is no indication that imports of other restricted goods, such as electronic products and automobiles, were seriously limited. The most noteworthy Canadian trade action was its decision to follow the United States in imposing a VER arrangement on imports of Japanese cars.

It is well known that Japan has emerged in the 1980s as a very significant exporter of capital. This has involved both financial capital and foreign direct investment. Japan had formerly concentrated its foreign direct investment in resource industries, but had switched to manufacturing toward the

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end of the 1960s. With the oil crises of the 1970s there was a renewed tendency toward foreign investment in resource industries, but this has changed once again as foreign investment in manufacturing and service industries has grown. Japan's direct investments in the United States have been concentrated in electric machinery, transport equipment, and metal products, all of which had been targets of U.S. import restrictions. Japan's direct investments in Canada have been primarily in resource-based industries. Foreign direct investment in Japan has also increased noticeably in the 1980s in a variety of manufacturing and service industries.

Sazanami cites evidence of product upgrading by Japanese exporters to the United States in response to the VERs on electronic products and automobiles. As mentioned, the U.S. restrictions also resulted in increased direct investment in the U.S. market. The Canadian restrictions may have had a similar effect, although some of the investment may also have been designed to take advantage of producing in Canada and exporting to the Untied States under the free trade provisions of the Auto Pact. Japanese automobile investments in North America will thus have an impact on both final products and parts, but it is possible that some Japanese investments may be directed towards certain newly industrializing countries (NICs) such as South Korea. The experience with U.S. restrictions on color TVs is interesting because it led to a shift in the development of other sources of supply in the American market. At the same time, Japanese producers increasingly shifted their production and exports to newer electronic products such as audio equipment and videotape recorders.

Sazanami notes that Japan's trade surplus reached a record high of \$9.8 billion in September 1986, which was more than a year after the ven had started to appreciate. Most of the change was in the value of exports, especially automobiles and parts, semiconductors, other electronic products, and machinery. The differential effects on imports and exports may be due to the fact that a substantial proportion of export contracts are expressed in yen, so that export prices may not respond until new contracts have been concluded. This is especially the case for VCRs and other electronic and electrical products, as well for automobiles. Yen appreciation appears to have had an impact on Japan's imports of manufactured products. Since the prices of crude oil and other raw materials declined, there was some increase in the import demand for these products. Japan's foreign direct investment seems to have also responded to the yen appreciation, with increased outflows to the United States and to other Asian countries whose exchange rates are pegged to the dollar. Sazanami concludes that Japan's trade and foreign direct investment will continue to respond to the yen appreciation and that there will be further changes, particularly in the composition of Japanese imports.

Sazanami draws a number of inferences from her analysis and discussion, as follows: