The New Era of Economic Policy Coordination*

from external policy coordination to coordinated structural adjustment

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If a truly global economy is to emerge after the coming world war ends, severe competition in trade and trade blocking policies will take place among nations, probably in a more aggresive manner than the period after the previous world war.

Tanzan Ishibashi (1956)

Coordination of macroeconomic policies is certainly not easy ; maybe it is impossible. But in its absence, I suspect nationalistic solutions will be sought... trade barriers, capital controls and dual exchange rate systems. James Tobin (1987)

I Introduction

The equilibrium growth theory is the main theme in the neo-classical growth theory, but there is always the action of the dynamic change from real economy upon the equilibrium. We will face the same situation between the process to the equilibrium and the dynamism to changes in the world economy.

We usually accept policy coordination with the prescription for disequilibriums. Coordination is not a new subject. Long before Bretton Woods gave way to floating exchange rate, coordination was discussed and sought. Everytime economists urge governments to coordinate policies, the financiers, journalists, scholars and politicians take up the demand. Central bankers and finance ministers agree, as do presidents and prime ministers. They meet, they talk, they announce progress. The need for coordination seems obvious from the imbalance of trade and gyrations of exchange rates in the 1980s. We have never agreed to the specific content of coordination, but when no other appealing solutions are evident, the coordination seems the natural panacea. The main mechanism of coordination was thought to be international respect for certain rules of the game.

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The rules concerned principally the obligations of surplus and deficit countries to take corrective measures. Some rules were actually prescribed in the Bretton Woods treaty, though with considerable ambiguity. Others were unwritten traditionst hat central bankers inherited from gold standard days.

The sovereign power of the state is waning slowly as a result of increasing flow of goods, capital, and corporations, but the state pretends and behaves as if its monopolistic power were permanent, so economists commonly observe. According to them the world is becoming increasingly borderless in economic sector and it is essential to coordinate policies in order to minimize distortions in the international movement of economic resources and external imbalances with the bilateral and multilateral negotiation. The Structural lmpediment lnitiative(Sll) is the first attempt for two sovereign, yet closely interdependent nations to discuss the problems of and to change their domestic structures.

To learn from the experience of the relationship between Japan and the United States, we need a common theoretical framework and real meanings of coordination. Here we will start from the suggestion of the historical process of the negotiations between Japan and the United States. Then, we will discuss the necessity of policy coordination including bilateral and multilateral attempts through evaluating the case study of the Japan-U. S. relationship.

II Historical Survey of Japan-U. S. Negotiation

In the recent decade, the U. S.-Japan relationship was determined primarily by the so-called "economic friction" between the two countries.

Looking back at the recent developments, the following trends can be derived.

First, the area of friction has expanded from individual industries, to sector-specific talks, to structural problems. While the issues of steel, textile and automobile still are discussed on an individual basis, the scope of the negotiations expanded to comprehensive measures such as the MOSS (Market Opening Sector Specific) negotiations, and finally, to the Sll (Structural lmpediment lnitiative) discussing precisely the structural issues.

Second, along with the first trend, the content of the friction, or the objectives of the negotiations has shifted from protective measures for the U. S. market, such as price restrictions or voluntary export restraints to stop the "flood of export" from Japan to the United States, to market opening measures targeting the Japanese market, demanding expansion of domestic demands and access to the Japanese market.

The third trend is the first step toward policy coordination, that is, shift from one-sided policies, mainly from the U. S. to Japan, to cooperative measures between the two countries, in forms of macroeconomic poliy coordination.

As the budget deficit, high dollar and high interest rate policies of the first Reagan administration accelerated tha expansion of the external imbalances of the U. S. in 1982, the U. S. deficit toward Japan soared to over 15 billion dollars. Furthermore, in 1985, the United States fell from the status of the world's largest creditor nation to the world's lagest debter nation while on the other hand, Japan became the world's largest creditor nation. lnevitably, this intensified the economic friction between the two countries. This is exemplified in the number of anti-Japan or protectionist bills proposed in the U. S. congress, which reached almost 300 in this time period.

Alamed by such antagonistic mood and protectionist sentiment, the Reagan administra-

tion seeked an alternative measure to cope with the problem of the current deficit. And on September 22, 1985, the first form of dolicy coordination, the Plaza agreement was made.

In this agreement, which involved not only the United States and Japan, but the five industrialzed countries, (G5), the importance of rectifying the trade imbalance for the well being of the world economy was mutually recognized. Actions were made in forms of joint intervention into the exchange market to devalue the dollar, and individual fiscal policies of each country with emphasis on the budget deficit reduction of the U. S. and expansion of domestic demand in Japan and Germany (former West Germany).

As a result, the value of the dollar dropped drastically, over 20% in the first two months. The commitment for policy coordination actualized in forms of domestic demand expantion efforts of Japan such as the Maekawa Report in April 1986, and the Action Program in April 1986, and the Action Program following this report. On the U. S. side, the Gram-Rudman Hollings-Act was enacted, as to rectify the budget deficit by regulative measures.

Overall, the recent developments in policy measures taken against U. S.-Japan economic friction can be characterized in the following three trends; the shift from specific to structural issues, the change in focus from border control to market access (external policy to internal policy), and the rise of cooperative framework, (economic policy coordination) between the two countries.

III Japan-U. S. External Competitiveness Study

(1) *External Competitveness Index Approach*

In this section, we examine the background of U. S.-Japan trade imbalance through an analysis of "competitiveness" between Japan and the U. S.

International competitiveness is expressed by an international comparasin of the structure of comparative advantage. It can also be expressed by translating the leveled division of labour index from a bilateral to a global scale.

Here, we translate this leveled division of labour index as indicators of a country's competitiveness. Therefore, the formula is;

$$\frac{\text{Total world export of } i \text{ product of a country}(Ei) - \text{Total world import of } i \text{ product of a country}(Mi)}{\text{Total world export of } i \text{ product of a country}(Ei) + \text{Total world import of } i \text{ product of a country}(Mi)}$$

The concept of "competitiveness" originates from the "product cycle" theory[1)2)]. In this uheory, the development of one product is considered to be a cycle of import, domestic production, and export. Therefore, if we look at the process of import reduction and export expansion as a reflection of the external competitiveness of a specific product, the index figure−1 indicates specialization, and+1 indicates export specialization.

[Competitiveness of Industrial Products]

The following figures (attached) show the changes in the competitiveness of industrial goods of Japan and the U. S., Industrial goods, as defined here, is the sum of industrial

1) R. Vernon, "International Investment and International Trade in Product Cycle", *Quarterly Journal of Economics*, Vol. 80, May 1966

2) Kimio Takanaka, "*The The Theory of Multinational Corporation(Takokuseki Kigyo-ron)*" Tanizawa-Shobo Publishing Co., 1991

External Comptitive Index Trends (1962—1987)

Figure 1 SITC 5 — 9

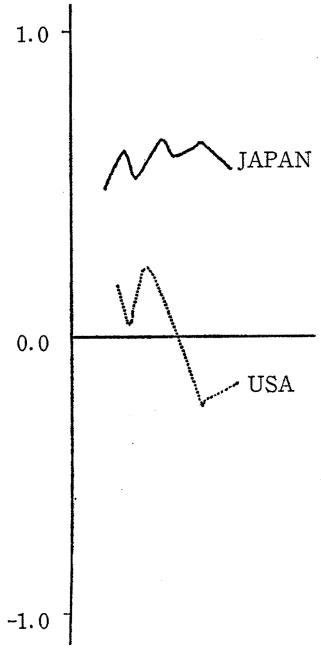


Figure 2 SITC 5

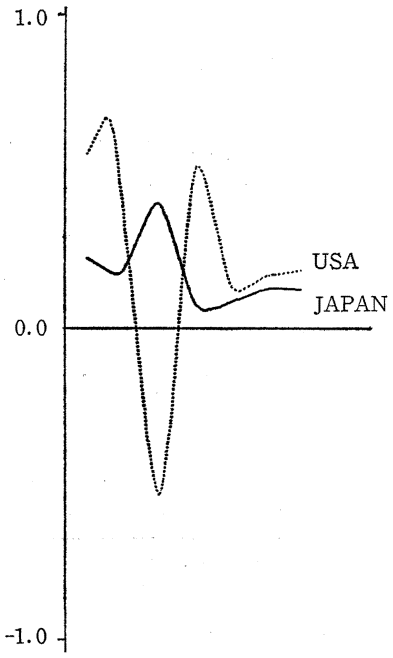


Figure 3 SITC 6

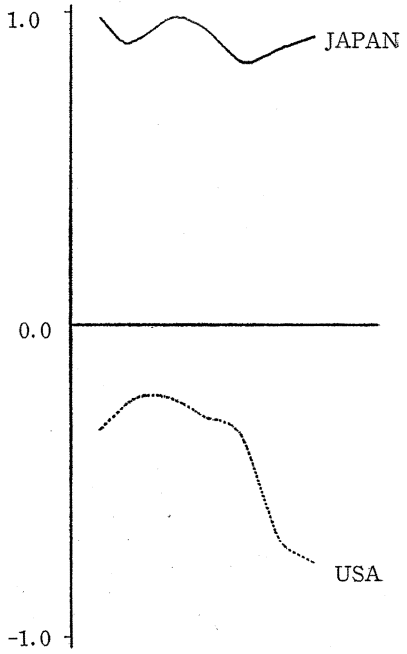


Figure 4 SITC 7

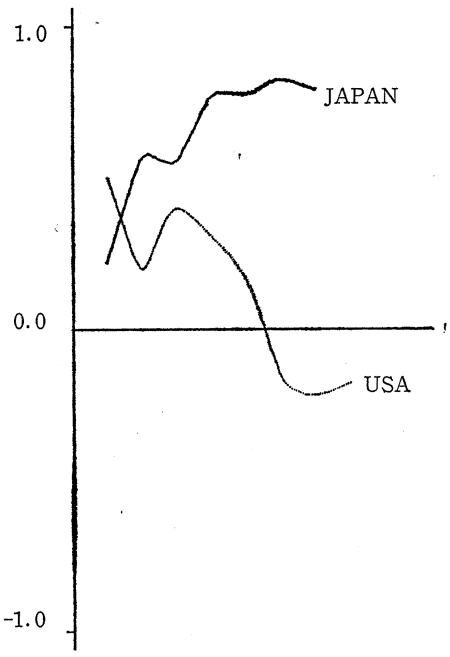
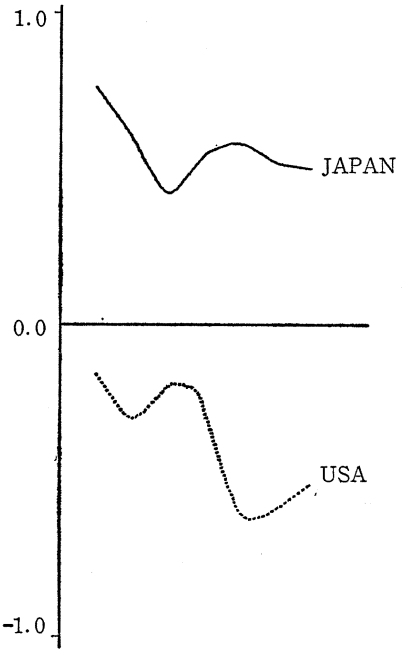


Figure 5 SITC 8



products as classified in the Standard International Trade Classification (SITC) as follows : section 5 (chemicals and related products), section 6 (manufactured goods classified chiefly by material), section 7 (machinery and transport equipment), section 8 (miscellaneous and manufactured articles), and section 9 (commodities and transactions not classified elsewhere in the SITC).

According to this index, the industrial competitiveness of Japan, after reaching the level of 0.49 in 1962, stayed around the level of 0.60 to 0.65 until 1986, expect for 1970 when the figure was 0.52. However, in 1987, the figure dropped to 0.57.

In the case of the United States, its competitiveness dropped considerably from 0.19 of 1962 to-0.26 in 1986, and has recovered slightly in 1987 to about-0.13[3].

This 'rise and fall' of competitiveness exactly corresponds to the stages of development as discussed in the product cycle theory. If we measure Japan's industrial competitiveness historically, we can see a constant rise ; the index figure was-0.50 in 1880, but converted to a positive figure in 1900, and has risen ever since. Therefore, we cen see that the competitiveness index changes in the order of Japan, then the U. S. and European nations, in accordance with the industrial development of each country.

[Item-Specific Evolution of the Competitiveness Index]

Next, what can we say ebout the evolution of the product-specific competitiveness index ? The figures illustrate this evolution.

When we look at the competiveness index of chemical products (SITC 5), we can see

3) Kimio Takanaka, Toshio Watanabe and Hirokazu Kajiwara, *"Asia Sogoizon no Jidai"* Yuhikaku Publishing Co., 1991

a drastic shift in the competitiveness of both countries. However, this is due to the drastic change in the international environment caused the oil crisis, and overalll, both Japan and United Stated has recorded a moderate rise in the competitiveness of this sector, and the United States still exceeds Japan in this sector.

The evolution of the competiveness index of machinery and transportation equipment sector (SITC 7)is an interesting case. It gives evidence to the claim that the process of industrial development proceeds in the order of non-durable goods, durable goods, and then capital goods. In 1962, the United States maintained a high level of 0.49, while Japan's figure was 0.22. However, since then, the United States followed a downward trend, while Japan rapidly increased its competitiveness, reaching the figure of over 0.80 in the 1980s.

Overall, aside from SITC 5, Japan maintains higher competiveness than the United States in each sector. Thus, we can conclude that excessive export of Japan and the excessive import of the United States is an extremely logical (rational) trend from the standpoint of the Product Cycle theory.

(2) *International Balace of Payment Stages Theory Approach*

The international balance of payment stages approach by Charles Poor Kindleberger[4] links economic development with the international balace of payments.

According to this theory, countries that are in the primary stage of economic development rely on capital from overseas, thus start out as an debter nation. However, as economic development proceeds, a country gains international competitiveness, and the international balance of payments turns to a surplus.

In other words, starting from an "inmature debter nation", as export industries are nurtured, a country enters the stage of a "mature debter nation", whose balance of goods and services account turns to a surplus but the current balance still maintains a deficit.

Next, as the amount of surplus of the goods and services account increases, and reaches the level as to supplement the deficit in the investment earnings account, the current balance of payments turns to a surplus and the country becomes a "debt repaying nation"

The following stage is "inmature creditor nation", where both the goods and services account and the investment income account, i. e. the current balance of payment turns to a surplus. Reflecting this to Japan's experience, Japan entered the stage of "debt repaying nation" in 1964, and reach the stage of "inmature creditor nation" in around 1971[5].

The next stage after the "inmature creditor" is the "mature creditor nation", where the goods and services accout turns to a deficit along with the loss of international competitiveness. Furthermore, as this deficit becomes massive as to exceed the surplus in the investment income account, the current balance also begins to show a show a deficit, and the country becomes a "credit breaking nation".

In the case of the United States, The goods and services account turned deficit in 1966, and after 1982, the current balance of payments also turned defici tIn 1985, the U. S. became a debter nation, but since the investment income account still maintains a

4) Charles P. Kindleberger, "*International Economics*" Richard D. Irwin, Inc., 1953

5) Kimio Takanaka, Toshio Watanabe and Hirokazu Kajiwara,"*Asia Sogozon Jidai*" Yuhikaku Publishing Co., 1991

surplus, it still remains at the stage of a "credit breaking nation"[6].

(3) *Other Approaches: Paul M. Kennedy and MIT Survey*

From the late 1980s, the issue of productivity, especially focusing the competitiveness of the U. S. industry, has attracted interest not only amonq the industrial leaders but also among the policy makers of the United States. Serious debates have taken place, reflecting this interest, and the report by the MIT commission on industrial productivity, later published as "Made in America" is the most representary of such debate.

This report, which was published in 1989, is the product of 2-year close examination of the reasons of productivity loss in the United States, and the prospects fof revitalization in Japan, the U. S., and Europe.

Emphasizing that the U. S. now has a serious productivity problem, the commission claimed that the causes of this problem "go well beyond macroeconomic explanations of high capital costs and inadequate savings, to the attitudial and organizational weaknesses that pervade America's production system"[7].

The causes are summarized into six points, (1) out-dated strategies insisting on large-scale production system, (2)short time hroizons, (3) technological weaknesses in development and production, (4) neglect of human resousces, (5)failure of cooperation, and (6) government and industry at cross purposes. Five proposals are made, in order to cope with these problems, such as (1) focusing on new fundamentals of manufacturing, (2) cultivation of a new economic citizenship in the work force, (3) blending cooperation nd individualism, (4) learning to live in the world economy, and (5) providing for the afuture.

Paul M. Kennedy, in his paper, "*What the Structural Impediment Initiative Cannot Do*"[8], also raises the issue of industrial competitiveness. He derives the case of German and British auto industries in the 1960s to 1970s, and points out the importance of industrial competitivenss in the world market, and points out the limits of macroeconomic type solutions to the trade imbalance, which he points out to be a reflection of a country's competitiveness.

He discusses as follows : In the case of German and British auto industries, macroeconomic solutions, such as intervention in the exchange rate and alternation in the commercial sectors wers seeked, in order to rectify the trade imbalance between the two countries. However, these solutions did not prove to be successful. What came about was that the fundamental source of the imbalance was the imbalance in the quality of the product.

Appling this experience to the U. S. -Japan trade problems, Kennedy concludes that (1) it is no use focusing upon Japan's structural impediments without placing equal or greater attention upon U. S.'s own impediments, such as a propensity for short-term profits.

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6) Kimio Takanaka, Toshio Watanabe and Hirokazu Kajiwara, "*Asia Sogoizon no Jidai*" Yuhikaku Publishing Co., 1991

7) Michael L, Dertouzos, Richard K. Lester and Robert M. Solow (ed.), The MIT Commission on Industrial Productivity, "*Made in America—Regaining the Productive Edge*" The MIT Press, 1989

8) Paul M. Kennedy, "*What the Structural Impediment Initiative cannot do*" MITI Journal, Nov. 1990

over long-term market shares, weaknesses in public education and technical training, and overproduction of lawyers, accountants, and MBAs as opposed to the underproduction of engineers, (2) structural, or macroeconomic changes by themselves are no guarantee of altering trade imbalances unless they are accompanied by very significant increases in the quality of the goods being produced.

Though the MIT report and Kennedy's analysis differ in its focus, they both agree on the importance of industrial competitiveness in the overall economic permance, and that this is the fundamental source of the trade imbalance between nations. They will both agree that "if one thousand U. S. companies were to be more successful, the trade imbalance would most probably be a thing of the past"[9].

IV Actual reason of external imbalance butween Japan and the United States

Three times from the late 1960s till now, Japan has experienced a massive imbalance in the external balance of payments (surplus in current balance of payments); first from the year 1971 to 1972, second from 1977 to 1978, and third, after 1983.

The current imbalance exceeds that of the previous two cases in both its magnitude and continuancy. However, it is also true that both of the previous imbalances were "interrupted" by the oil crises ; suggesting that the first two periods of imbalances might have persisted as long as the current case, if it were not for the rise of oil prices.

We will further discuss this point later, but these experiences suggest that the economic structure of Japan lacks an adjustment mechanism, to adjust the current balance of payments, and due to this lack of a mechanism, a massive surplus has persisted unless special incidents, such as the oil crises occur.

From a macroeconomic point of view, surplus in the current balance of payments means nothing else but that a country's domestic savings is exceeding its domestic investment, and that the excess savings are invested overseas. Therefore, as long as the excess savings flow smoothly overseas to an investment-excessive country, it should not be a global problem, even if one country's surplus in the current balance of payments should continue.

However, in reality, the persistance of massive surplus of one country's current balance of payments has intensified economic frictions among nations.

In times when all countries hold excess savings and each are in a stage of imperfect empoloyment, a country with overly excessive savings is criticized as being "mercantilistic" or to be promoting a "beggar my neighbor" policy. Furthermore, it creates an environment where all nations are forced to take protectionist measures, such as import restrictions, in order to protect their own employment.

Even when this is not the case, when the current balance of payments consists mainly of trade surplus, import excessive countries are forced to implement industrial adjustment on the one hand, and on the other hand, calls for protectionism arise.

In thie context, it is necessary for countries that tend to cause massive excessive imbalances to prepare an adjustment mechanism in order to adjust external imbalances, before such imbalances cause excessive tension to the global economy and aggrevate the

9) ibid. pp. 5

maintenance of the transaction of goods across all nations[10][11].

(1) *Case Study : Japan*

One way to examine why Japan's current surplus suddenly expanded greatly after 1983 is to perform a counterfactual simulation.

The size of an external imbalance is determined by 1) the effects of overseas and domestic factors on the current balance of payments, and 2) effects of private and public sectors on the savings and investment balance.

Taking this into account, the following steps are taken in a counterfactual simulation.

Actual changes in the external variable, (including sub external variables, as we will discuss later), which is assumed to have played an important role in this process is examined, then the size of current surplus in case such changes had not occured is examined.

In detail, a baseline is created by giving an actual figure to the external variable, and then this baseline is compared with each of the external variable obtained when the time pass is changed. The seven factors we pick up here, is a) oil prices (dollar basis), b) import price of non-fuel products, c) import quantity of fuel, d) U. S. long-term interest rate, e) real fixed public investment of the public sector, f) corporate tax rate and taxed income rate, and g) money supply.

Of all these variables, import prices of non-fuel products, and money supply are internal variables in this model, but are explained only by external variables, (or policy variables). Import quantity of fuel is originally an internal variable, but we will explain this in detail later in this section.

Table 1 Effects of factors contributing to the expansion of external imbalances billion(dollars)

Year	(a)	(b)	(c)	(d)	(e)	(f)	(g)	Total	Current Balance (Real)
1980	—	—	—	− 0.6	5.1	—	—	4.6	−10.7
1981	—	2.9	5.0	3.8	1.8	1.0	—	14.5	4.8
1982	—	4.5	3.6	6.2	5.2	1.6	0.5	21.7	6.9
1983	—	4.0	4.1	5.0	9.3	2.4	0.5	25.4	20.8
1984	1.6	4.5	1.9	4.6	13.6	3.5	1.8	31.4	35.0
1985	3.1	8.3	2.0	11.2	20.3	4.4	2.5	51.3	49.2
1986	29.9	4.6	−0.9	4.2	24.5	6.7	4.4	71.6	85.8
1987	11.8	0.0	0.3	4.8	27.5	9.7	5.4	53.4	87.0
1988	20.3	1.8	0.0	4.8	32.1	13.4	7.2	74.9	79.6
1989	3.1	1.3	0.5	2.9	38.9	17.7	8.0	66.0	57.2
Total	50.0	32.0	16.6	47.0	178.2	60.4	30.3	414.5	414.6

First, the international price of oil (annual average) evolved around 30–40 dollars per barrel from 1980 to 1982, but began to fall after 1983, and after it reached the 27.6 dollar per barrel level in 1985, finally dropped to 14.4 dollars per barrel in 1986. Now until 1989, the prices are floating around the range of 15 to 19 dollars per barrel.

Since the price elasticity of import demand of fuel is quite small in a short term, rapid

10) Kimio Takanaka, M. Hirai, N. Tsuruta and K. Matsuda, "The New Era of Japanese Economy (Shinjidai no Nihon Keizai)" Jicho-sha Publishing Co, 1990

11) Akihiro Amano, *"Japanese External Imbalance"*, Working Paper No. 9015, School of Business Administration, Kobe University, Sept. 1990

fluctuations of prices as such will greatly influence the amount of fuel import. Table 1 column (a) shows the the size of the current surplus at the baseline compared with the model solution which assumes that the nominal price of crude oil is maintained at the high rate of 29.4 dollars per barrel of 1983. 1986 (22.9 billion dollars) and 1988 (20.3 billion dollars) are the years with the most visible effect, but the accumulated amount from 1984 to 1989 is 50 billion dollars.

Secondly, Japan's dollar-base import price excluding fuel has been low after the peak of 1980, due to the fall of the price of primary goods and the fall of dollar-base price of manufactured goods, and it was only in 1988 that it finally exceeded the level of 1980. The comparable case here is the case where the import price excluding fuel maintained the level of 1980 between 1981 and 1986. According to Table 1 column(b), the size of the current surplus which expanded due to this factor was 8.3 billion dollars at the most, (1985), and the accumulated amount from 1981 to 1989 was only 32 billion dollars.

Third factor is the import volume (actual imported amount) of fuel. As Table 1 shows, Japan's actual amount of fuel import dropped greatly from 1980 to1985, and then recovered in 1986 after the fall of oil prices in 1986. The shift in the early half of 1980s, needless to say, was the effect of the hike of the actual price of oil prior to that appearing after a long time lag, and this has contributed to the expansion of current surplus of this period. However, this variable is not an external variable, so the simulation was conducted by giving the database externally and by keeping the figure fixed at the level of 1981 for the period of 1981 to 1985.

As column (c) of Table 1 indicates, the effect of this was also limited, the accumulated amount between 1981 and 1689 was 16.6 billion dollars.

Fourthly, the U. S. long-term interest rate (yield of 10-year government bonds)shifted around the two digit level from the period of 1980 to 1985 as a consequence of the U. S. authority's tight financial policy. Excluding the short-term J-curve effect, high interest rates in the U. S. on the one hand, increases surplus in the trade balance by decreasing the value of the yen. On the other hand, this becomes the pressure to pull up the domestic interest rate and builds up the current surplus by restraining domestic economic activities.

This simulation is under the assumption that the U.S. long-term interest rate remained at the level of 9.44% of 1979 from the period between 1980 to 1985. As Table 1 column(b) indicates, the U. S. high interest rate contributed considerably to the expansion of the current surplus. Furthermore, the effect of decelaration of economic activities persist with a time lag, so even after 1986, the size of the current surplus is larger than the standard case. The accumlated effect of this factor between 1980 and 1989 was 47 billion dollars.

The following factors 5 through 7, as opposed to the external factors 1 though 4, are domestic factors.

Factor five, Japan's actual public investment, had increased at the high level of average 14.5% from 1961 to 1970, and 7.8% from 1971 to 1978. But as the massive government bond fees began to pressure the government's budget, the Japanese government decided to implement budget reconstruction measures after 1979, and public investment was restricted to the growth rate of average-1.6% between 1979 and 1985. The assumption here, was that the real public investment in the period between 1980 to 1985 increased at the annual rate of 3.5%, slightly lower than the average growth rate of 4.0% between 1986

to 1989. In this case, the real GNP growth rate in the entire period of 1980 to 1989 was average 0.23% higer than the standard case, and as Table 1 column (e) indicates, the rate of current surplus was greatly reduced. The amount of accumulated surplus growth between 1980 and 1989 has reached 178.2 billion dollars. Therefore, it is important to note that pursuit of the goal of budget reconstruction produced two large side effects: expansion of external imbalance and rise of protectionism overseas.

The stance of tight fiscal policy is also reflected in tax policies. Namely, corpoate income tax rate was raised several times after 1981, and the rate of taxable income against the nominal GNP is on an upward trend after 1979.

Column(f) of Table 1 indicated how much larger the amount of current surplus was kept at the same level after 1980 and the rate of taxable income against the nominal GNP was also kept at the same level after 1981. The effect of this is not as large as column(e), but still, the accumulated amount between the years 1981 to 1989 reached 60.4 billion dollars.

The last factor is related to monetary policies. Money supply of Japan (M2 plus CD) in the broad sense increased at the high rate of average 16.3% between the period of 1970 to 1978, but its growth rate decreased to half, to average 8.5% in the same period. Needless to say, this reflects the anti-infationary tight monetary policy, and as a result, prices remained extremely stable, excluding the two years immediately after the second oil crisis. However, such tight monetary policies had its side effects as well: the expansion of the external imbalance.

Column (g) of Table 1 shows the comparison with the hypothetical case of 10% increase in money between 1982 to 1989, and the accumulated amount of surplus growth between 1982 to 1989 was 30.3 billion dollars, compared to the case when such tight monetary policies was not put into effect.

Table 1 column (h) adds up the amount of current surplus assumed to have been caused by the seven factors listed above, and we can understand that considerable portion of the result in column(i) can be "explained" by the effect of such factors.

Furthermore, from the analysis above, we can also see that the first four external factors (or the current account side) merely contribute to one third or 145.6 billion dollars of the accumulated amount of the surplus between 1980 and 1989. This means that the remaining two thirds of the surplus is based upon fiscal and monetary or investment and savings (I-S) balance, which are purely domestic factors. These latter factors are not external factors such as change in the external economic environment or accidental change, but purely internal or domestic factors, arising from the pursuit of domestic policy objectives. This fact exemplifies the deep relationship between the external imbalance and international economic frcition.

(2) *Case Study : TheUnited States*

In the fall of 1982. the Federal Reserve reversed the restrictive policy adopted just three years earlier. The recession turned out to be deeper than intended or expected. Recession and disinflation were endangering the fiancial institutions of the United States, and the world as debtors at home and overseas could not meet obligations incurred with

high expectations[12].

At the same time, the U. S. economy began to receive stimulus to demand from the federal fiscal policies set in place by the Reagan adminstration and the Congress in 1981, tax reductions plus a build-up defense spending incompletely offset by cuts in civilian spending. Together with the newly accomodative monetary policy, the fiscal stimulus generated a sharp recovery until mid-1984, umemployment fell from a peak of 10.7 percent to almost 7 percent. The Federal Reserve then slowed down the pace of real growth.

President Reagen, like the leader of other summit countries, is conservative, but his conservatism in economic policy is idiosyncratic. His fiscal policy differs radically from the orthodox austerity of his partners. The unique ingredient is the supply-side extremism associated with Arther Laffer, the fantasy that tax rate cuts will more than pay for themseives by revenues from the explosive economic growth they stimulate. In addition, but contradictory to the Laffer theory, Reagan's political strategy was to create deficits. Neither theory proved to be factually correct, the first because it truly was a fantasy, and second because the Congress, after acquescing defense spending than they wanted, used the deficit tit-for-tat to prod the President to tax increases.

The macroeconomic result has been an unprecedented bizarre and extreme mix of fiscal and monetary policy, making interest rates several points higher, after allowance for inflation, than in other recovery periods. Until mid-1985, these rates attracted world capital into dollar assets, appreciated the dollar, made U. S. products incompetitive, and generated an enormous trade deficit. In macroeconomic terms, U. S. net exports, national investments in clams on the rest of world, were crowded out by consumption stimulated by tax cuts and by defense spending. Domestic investment in business plant and equipment and in housing did not do well either. After an initial surge in 1983-84, the deterrent effects of interest rates and foreign competition overcame the tax incentives to investment enacted in 1961, were repealed in the tax reform of 1986.

Ironically, Reagan's supply-side policies had counter-supply-side results. U. S. real GNP was 18 percent higher in 1986 than 1978; final sales (omitting inventory change from GNP) were 925 billion U. S. dollars higher in 1986 prices. Of the increase, 97 percnt went to private consumption and government purchases of goods and services. Only 3 percent went for domestic investment plus foreign investment (exports net of imports), items that in 1978 accounted for 16 percent of final sales. Yet these are the uses of resources on which future U. S. living standards depend. Despite tax incentives for saving, IRAs and other deferments, private saving rates have declined, and of course the federal government has been dissaving 4 to 5 percent of GNP[13][14].

The United States has been stagnating on the supply side. The growth of potential output, reckoned at a hypothetical constant unemployment rate, appears to be only 2 or

12) Martin Feldstein(ed.), "*The United States in the World Economy*", The University of Chicago Press, 1988

13) James Tobin, "*The 1980s: A Decade of Stagnation?*", Lecture at The Center for Japan-U.S. Business & Economic Studies, New York University, October 1, 1987. Revised March 1988

14) Paul M. Kennedy, "*The Rise and Fall of the Great Powers*", The Random House, Inc. 1988

at most 2.5 percent per year, of which labor productivity growth is only half. As a consequence, real wage rate are about the same as in 1973. Real incomes per person have risen, because women work more and have fewer chilren.

In the 1960s, the trend of U. S. potential output was estimated at 3.5 or 4 percent per year, of which 2.5 or 3 percent was productivity growth. On the context of U. S. unemployment, unemployment is that the jobs created in the 1980s have produced so little GNP. A worldwide decline in productivity growth began in the early 1970s, about the same time as the first oil shock. Even economic expert on this subject do not understand its cause[15]. Obviously the period of Reagan's well-advertised supply-side policies have not paid off in the United States[16].

V. Conclusion : Policy Coordintion and Cooperative Structural Adjustment

From the previous analysis, we can come to a conclusion that (1) the product cycle theory and external competitive index approach adequately explains the current status of the trade inbalance between the United States and Japan, (2)suggesting that "competitiveness", and the industrial structure of each country are the fundamental elements determining the economic performance of the U. S. and that therefore, (3) specific, product oriented border control or external maternal macro-economic fiscal and monetary policy coordination has its limits in rectifying the trade imbalance.

Actual performance of the economy seems to be supportive of this claim. Although the dollar was devalued by 30% in three years after the Plaza agreement, it did not fulfill the high hopes of the policy makers as to diminish the trade imbalance. The domestic demand of Japan has been expanding, as to serve 6.8% of the actual growth rate in the year 1988, and the external demand has shown minus growth since 1986, but still, the imbalance exists.

The solution that we come to, therefore, will be structural adjustment of domestic economic structures, done in a cooperative manner as to rectify the trade imbalance. The task for Japan, will be to eliminate factors disturbing the expansion of domestic demand and to the market, and to provide free market access, and for the U. S.'s side, to enhance industrial productivity and strengthen international competitiveness. This opens the new era of policy coordination ; coordination of domestic economic policies, both macroeconomic and microeconomic.

Traditionally, we use microeconomic policy for improvement of efficiency for resource allocation and macroeconomic policy for stablizing price and maintaining stable economic growth rate. External imbalance exists in area of macroeconomic policies, but the policy for external imbalance is given less priority than any other main policy goal.

Recently the existence of external imbalance injures the efficiency of resource allocation, and it aggravates protectionism distinctly. In this situation, we must consider

15) Michael L. Dertouzos, Richard K. Lester and Robert M. Solow(ed.), The Commission on Industrial Productivity, "*Made in America-Regaining the Productive Edge*", The MIT Press, 1989

16) Kimio Takanaka, "*U. S. Fiscal Deficit and Economic Trends (Beikoku no zaisei-akaji to keizaidoko)*", The Journal of Japan Association of Business Cycles(Keiki to Saikuru), No. 11, November 1990

external imbalance deeply in both areas ; microeconomic and macroeconomic policies. Under the situation that a process of automatic adjustment mechanism for external balance hardly works, it is desirable to compensate it with measures of microeconomic and macroeconomic policies frow a viewpoint of actualizing original policy goals.

The Structural lmpediment lnitiative, which started between the United States and Japan in 1989, is the first step into this new era of policy coordination. The offical objective of the Sll is, "As a supplement to the ongoing efforts under the framework of policy coordination, to identify and solve the structural problems that exists as impediments in adjusting trade and the international balance of payments between the United States and Japan".

The issues being discussed were precisely the structural elements of both economies under re-examination. The topics of discussion on the Japanese side was, savings and investment patterns, land use, distribution system, exclusionary business practices, keiretsu relationships, and price mechanisms. On the other hand, the topics for the U.S. side, was savings and investment patterns investment activities and productivity of individual companies, corporate behavior, government regulations, research and development, export promotion, and worker training and education.

Internationl coordination of economic structures brings under light the internal domestic economic structure and practices, which were not topics of international negotiation, but rather, within the realms of national sovereignty. Therefore, the process of change will not be easy, since it will be a constant battle with the assersions of sovereignty of domestic economic policies. Furthermore, since the issues involved are "structural" issues, which cannot be changed in a day, it may not be a quick fix to the trade imbalance, and therefore cause political frustration.

However, there is no turning back. As the flow of goods, money and people becomes worldwide, any advanced nation is asked for a certain level of commonality with the rest of the world in their market and their rules[17].

The main meanings of policy coordination and adjustment is to decide mutual policy according to the measure of economic rationality and to maximize mutual benefit including national interest. Economic coordination can, under the right circumstances, make a positive contribution to world wide economic well being. It is important not to exaggerate it in ways that threaten broader political harmony[18].

17) Naoko Ishii, "*Seisaku Kyocho no Seijigaku (The Political Economy of Policy Coodination)*", Nihon Keizai Shinbun-sha, 1990

18) Martin Feldstein(ed.) "*The United States in the World Economy*", The University of Chicago Press, 1988