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BOOK REVIEWS

Bela Balassa and Marcus Noland, Japan in the World Economy (Institute for International Economics, 1988) pp. xii + 290, $14.95.

In the late 1980s, despite expansionist fiscal policies, Japan's current account in international transactions remains stubbornly in huge surplus and its relations with its trading partners, while increasingly intimate, are also increasingly contentious. In a new study for the Institute for International Economics, Bela Balassa and Marcus Noland attempt to provide a comprehensive look at these issues and make a series of policy recommendations which they hope will foster stability and harmony between Japan and the rest of the international economic system.

Economists with an interest in international economic policy will find most of the Balassa–Noland analysis and the associated policy recommendations entirely familiar. In the face of continuing current account surpluses Balassa and Noland recommend the adoption of a still more expansionary medium-term fiscal package by Japan supported by an accommodating monetary policy. Globally, Japan should take a leadership role in both the Uruguay Round and in the provision of collective international security. Finally, Japan should provide still further financial assistance to developing countries.

What is more distinctive and more controversial in this study is the Balassa and Noland emphasis on Japan's housing and land-use policies as a major contributor to its current account surplus. Somewhat less distinctive, but still more controversial, allegedly unfair Japanese trade policies and industrial policies are suggested as having played a major role both in keeping imports of manufactured goods as a very small share of Japanese GNP and in transforming Japan into an economic superpower in the late 1980s.

Balassa and Noland correctly note that the policy dilemma of Japan's external economic relationships can be resolved by a continuation of Japan's shift from export-based to domestic-based expansion. They suggest that the centerpiece of this Japanese shift should be continued reform of Japanese government regulations and practices which are thought to discourage residential housing investment. This general proposal is followed by detailed

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recommendations regarding which Japanese zoning regulations, land taxes and mortgage practices are most in need of change.

While from a quality-of-life-in-Japan perspective there is much to commend in many of the domestic policy changes advanced by Balassa and Noland, they are certainly not within the traditional purview of international economic diplomacy. If national sovereignty means anything, it must mean that the terms and availability of mortgages for residential housing are the traditional stuff of domestic politics. In an increasingly economically interdependent world, however, such attitudes are fast becoming outmoded. Nonetheless, before Japan's trading partners suggest changes in such sensitive matters, it ought to be fairly clear that new policies, if adopted, will have a directly beneficial impact on Japan's international economic relations. In the case of the Balassa–Noland proposals this remains an open question.

Changing Japanese land-use policies might well increase Japanese housing investment. The precise direction of the link, however, between such policy changes and household savings is more difficult to ascertain. Balassa and Noland argue that 'the combination of high housing costs and the strategic bequest motive ... provides a principal explanation for the high Japanese savings rate'. While Balassa and Noland do not study this question in detail, most recent studies by Japanese and American scholars on this subject do not support their argument at all. Indeed, the land-use policies Balassa and Noland propose, through their negative impact on Japanese wealth held in land, could plausibly stimulate an increase in Japanese household savings. It is entirely possible that this increase might be large enough that, on net, the housing and land-use policy changes Balassa and Noland propose could result in an increase rather than a decrease in Japan's current account surplus.

The possibility that the Balassa and Noland domestic policy proposals, through their impact on Japanese trade structure, might complicate rather than simplify Japan's relations with its trading partners should also not be overlooked. A substantial further decline in the size of Japan's agricultural sector in the interest of lowering the price of land available for residential housing will substantially increase Japanese imports of agricultural products. At the same time, however, it is just possible that Japan's imports of manufactured goods might decrease and/or Japanese exports of manufactured goods might increase as a direct result of these same policies. The international economic order applies very different standards to trade in manufactured goods and trade in agricultural products. From this perspective it certainly is possible that not only by the standard of its impact on the current account surplus, but also by the standard of its impact on trade structure, the Balassa–Noland domestic policy proposals for Japan might backfire.

Since at least the days of the Carter Administration, it has been attractive to Americans seeking to ameliorate international economic tension to make common cause with the widespread Japanese desire for better housing conditions and to advocate domestic policies of the sort Balassa and Noland propose. It is a pity Balassa and Noland did not treat these complicated issues in a more systematic fashion.

The second distinctive element of the Balassa–Noland study is an analysis of Japan's trade and industrial policies and their impact on Japanese import volumes, Japanese trade structure and the structural transformation of the Japanese economy. Balassa and Noland find that whether total imports or just imports of manufactured goods are considered, Japan imports significantly less than would be expected from a country with Japan's economic attributes. This finding is based on an analysis of cross-national differences in the ratio of imports to gross domestic product.

Unfortunately, the Balassa–Noland analysis will not stand close scrutiny. In examining whether Japanese trade behavior is distinctive, it is important that whatever conclusions might be derived should not rest heavily on entirely arbitrary choices made in the course of statistical analysis. This is why most economists like to have a fully articulated theoretical structure to support whatever data analysis they might conduct. Surprisingly, rather than being guided by theory, Balassa and Noland either choose to estimate equations for which there is no theoretical basis at all or, where a theoretical basis does exist, Balassa and Noland choose algebraic forms and explanatory variables which theory specifically excludes. Since their regression equations are inherently mis-specified, it is difficult to draw any particular inference from the information that such analysis overpredicts the volume of Japanese imports or, for that matter, from the information that the same analysis shows that European Community (with its notoriously protectionist Common Agricultural Policy) is uniquely hospitable to imports of primary products!

Even if their equations were not mis-specified, finding that a trade dependence equation estimated with cross-national data overpredicts Japanese imports does not necessarily mean that Japanese trade policies are to blame. For example, it is entirely possible that restrictions by Japan's trading partners on Japanese exports might leave the Japanese current account balance largely unaffected. In this situation, foreign restrictions could distort Japan's imports almost as much as Japan's exports. When Japan joined the GATT in 1955, it still continued to face special discrimination in overseas markets. Fourteen countries (including the United Kingdom, France and Australia) and their dependent territories did not extend most favored nation treatment to Japan as they were permitted to do under Article 35 of the GATT. Today, the United States and many European countries maintain formal and informal restraints on Japanese automobiles, steel, machine tools and semiconductors, among other products. A distinctively low Japanese volume of imports can be attributed to distinctive overseas discrimination against Japanese exports just as easily as it can be attributed to Japanese discrimination against imports. For example, the Balassa and Noland regressions show sharply increasing underprediction of Japanese imports between 1980 and 1984. This is not a period of increasing Japanese protection. It is a period, however, of sharply increasing discrimination against Japanese exports in overseas markets.

The Balassa and Noland study provides an extended treatment of what are alleged to be Japan's informal trade barriers. Numerous instances of restrictive administrative guidance, customs procedures, standards, testing and certification requirements, public procurements, defenses for depressed industries and regulations regarding intellectual property and distribution channels are cited and discussed. Unhappily, the Balassa–Noland discussion lacks a comparative dimension. None of the examples Balassa and Nolan cite is unique to Japan. For example, Balassa and Noland highlight R&D subsidies given Japanese industry apparently not realizing these subsidies were provided via an R&D tax credit which was not nearly as generous as the R&D tax credit available to American industry. Japan has many formal and informal non-tariff barriers, but in the 1980s so do the United States and the European Community. The real task is to show, as Balassa and Noland clearly have not done, that the many Japanese cases cited add up to a set of Japanese policies that are uniquely trade distorting.

Curiously, much of the evidence that Balassa and Noland assemble on Japan's unfairly restrictive practices towards manufactured imports come from official and unofficial sources in developing countries. At the same time, Balassa and Noland's preferred regression equations do not find that Japan is underimporting from developing countries. Balassa and Noland do not comment on this important inconsistency in their findings but this does suggest a broader problem with the evidence they present. There is good reason to believe that the detailed observations about the difficulties imports face in entering the Japanese market come from just one tail of the distribution of foreign experience with Japan. The other tail of this distribution, filled with success stories of foreign companies that have persevered and achieved great success in Japan, has also been carefully investigated by American and Japanese journalists. What is really needed is a survey which covers the entire range of foreign experience with Japan. An unbiased sample of evidence must include (1) the experience of current participants in the Japanese market; (2) the experience of those who have departed in frustration; and (3) the experience of those who have been deterred from entering or have otherwise chosen not to do so.

In the three years since the sharp appreciation of the yen began, Japanese imports of manufactured goods have grown 120 percent. In the perspective of this performance and in the absence of unbiased sample evidence, it is difficult to see how the blanket charges of uniquely unfair Japanese trade practices made by Balassa and Noland can be taken at face value.

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Francesco Giavazzi, Stefano Micossi and Marcus Miller, eds., The European Monetary System (Cambridge University Press, Cambridge, 1988) pp. xx + 424, $59.50.

This book contains papers presented at a 1987 conference entitled 'The European Monetary System'. The book presents a very good overview of the state of the debate about the functioning of the EMS, and the introduction by Niels Thygesen presents an excellent summary of the contributions to the volume. The questions addressed by the authors are numerous and important.

The first question is: Is the EMS a cooperative symmetric fixed exchange rate regime where the burden of pegging exchange rates is cooperatively shared by all members, or rather a leadership system where a center country sets the monetary policy of the union and the follower countries passively adjust their monetary policy? Most of the participants to the conference appear to agree with the characterization of the EMS as an asymmetric regime with German leadership. The paper by Cristina Mastropasqua, Stefano Micossi and Roberto Rinaldi presents evidence to that effect. First, most of the interventions in the EMS are intramarginal rather than at the margins, implying that the burden of adjustment is on the weak currency countries. Second, Germany appears to sterilize its interventions in exchange markets more systematically than other EMS countries. These observations imply that a system conceived de jure with cooperative intervention rules has turned out de facto to be an asymmetric leadership system. Massimo Russo and Guiseppe Tullio rightly argue that reforms of the EMS in the direction of a truly symmetric system should include rules that prevent sterilization policies from undoing the effects of exchange rate interventions on the money supplies of the EMS countries.

A number of contributions to the book discuss the role of the EMS in leading to a convergence of inflation rates of member countries. Giavazzi and Giovannini restate the 'imported credibility' argument that a system like the EMS might help high-inflation countries to reduce their inflationary bias by credibly pegging their exchange rates to the currency of the low-inflation center country. The evidence presented by Giavazzi and Giovannini and Susan Collins on this 'monetary discipline' hypothesis is mixed. Inflation