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PRIME MINISTER'S VISIT TO THE FAR EAST

16-29 SEPTEMBER 1982

JAPANESE ECONOMY - INTERNATIONAL IMPLICATIONS

Brief by HM Treasury

POINTS TO MAKE

(i) Japan has benefitted from open world trade and financial systems - particularly in past few years when it has surmounted second oil price shock more successfully than other industrial countries.

(ii) This was achieved to a significant extent through reliance on external demand. Growth of protectionist pressures and slower world trade however, led to slowdown in Japanese economy last winter and showed problems such a policy can cause.

(iii) Japan and international community therefore both have an interest in greater Japanese reliance on domestic growth. Welcome recent signs of modest recovery in Japanese domestic economy. Important that this should continue.

(iv) Recognise importance Japanese government attaches to reducing budget deficit in medium-term, but share view of IMF staff that Japan should take account of short-term prospects for private demand in deciding how fast to reduce its budget deficit. Too fast a reduction could once again encourage Japanese companies to return to aggressive export marketing.

(v) Large Japanese private savings should make it possible to finance budget deficit without putting undue strain on credit markets, as long as government bond yields are consistent with market rates.

(vi) Important that yen should reflect fully competitive strength of Japanese economy. Current level lower probably than either Japanese or rest of world would like. Important now that US interest rates are falling that unduly easy monetary policy in Japan should not hinder recovery of the yen.

(vii) In the longer-term, liberalisation of domestic financial markets to make the yen more attractive to foreign investors, coupled with development of the yen's role as a reserve and trading currency, should contribute to maintaining a more realistic value for the yen.

BACKGROUND

Japan adjusted to the second oil price shock more successfully than competitors. GDP growth averaged 3½ per cent per year in 1980 and 1981, compared with less than 1 per cent in other Summit countries. The year-on-year rate of increase in consumer prices has fallen to 2 per cent, compared to still almost 9 per cent on average in other major countries. Unemployment is currently 2¼ per cent, and although this probably understates the true figure, the underlying level is well below the 8-9 per cent average elsewhere. The current balance of payments which showed a deficit of $11 billion in 1980, moved into a $5 billion surplus last year and achieved a further $3½ billion surplus in the first half of this year.

2% infl.

2½% unemploym.

BoP
1980 −$11 bi
81 +$5 b.
82 +$7 bil(?)

83 +$20 (OECD)
~~83~~ $17 (IMF)

Macro-economic policies may have had impressive results for Japan in the short term but they have increased protectionist pressures. Canada asks that they be reduced when Japan's policies have resulted in increasing them.

Xports up 18%
Imp. -1%

2. This impressive performance has not been without its problems both for other countries and for Japan. Growth in 1980 and 1981 relied heavily on external demand with exports of goods and services rising by almost 18 per cent a year, while imports rose less than 1 per cent a year. The external sector accounted for three quarters of Japan's growth over these 2 years. Some switch of resources into the balance of payments after the rise in oil prices was natural and desirable, but both the speed and size of Japan's adjustment has provoked international criticism. At a time when many other countries are suffering high unemployment, it has also added to protectionist pressures.

3. The dangers of relying too heavily on external demand were brought home to the Japanese at the end of last year when the combination of a slowdown in world trade and restraints on Japanese exports caused a fall in GDP. Growth recovered gradually in the first half of this year with at least a temporary pick up in domestic demand, particularly private consumption. Investment, however, has been sluggish, and Japanese companies have been trying to adjust down their stock positions to the unexpectedly low level of activity. Exports and imports have both remained broadly flat. Industrial production fell in the early months of the year, and may only now be levelling out again.

4. It is clear that the official growth target of 5.2 per cent for this year, which the Japanese now acknowledge was over-optimistic, will have to be revised down. The OECD and IMF both put the likely outturn at closer to 2 per cent. Both expect rather faster growth for Japan of 3-4 per cent in 1983. These forecasts, however, rely on external demand again playing a significant role. The OECD expects export growth to outstrip imports to bring a $20 billion current surplus next year. The IMF puts the surplus only slightly lower at $17 billion.

2/3 ~ in 3 mths
Japan somewhat less

5. Criticism of Japan has tended to centre on the macro-economic policies the Japanese pursue and the rigidly controlled non-market nature of parts of the economy. These two factors have at times tended to reinforce each other. The need to follow policies which take account of their impact on other countries was the central theme of the Versailles communique. The argument that countries such as Japan which have benefitted enormously from free market open trading systems, should also open up their own economies, similarly has a powerful logic.

6. Our own concern about Japanese macro-economic policies was expressed in the Assessment that we prepared for the Versailles Summit participants. We argued that Japan's macro-economic policies have tended to increase her reliance on external demand. Unduly stringent fiscal policies and, in particular, a rising tax burden have tended to hold back domestic demand. Japan's general government budget deficit was reduced from 5½ per cent of GDP in 1978 to 4 per cent last year, and the OECD Secretariat forecasts that it will fall to 2 per cent next year. This is likely to be about half the average level in other major countries (except the UK). It is particularly low taking account of the high level of private savings available in Japan.

7. The Japanese response is that the Government has a political commitment to abolish the current account budget deficit by 1985; it is already bringing forward public works to sustain domestic activity; and the lower than expected growth in the economy is causing upward revisions to the budget deficit. We share of course the Japanese desire that medium term budget deficits should be reduced. Our concern is about timing. This is echoed in the IMF's latest World Economic Outlook which argues that Japan's reductions in its deficit should take account of the likely growth of domestic demand to fill the gap. Mr Komoto, Director of Japan's Economic Planning Agency and one of Mr Suzuki's rivals,

has pursued a similar theme and the EPA is working on various reflationary packages.

8. Alongside this tight fiscal policy, Japan has followed a relatively accommodating monetary policy. M2 growth in the past two years or so has typically been around 9 per cent - rather faster than the rise in nominal GDP. Nominal interest rates have been well below those abroad and the yen's effective rate has fallen about 10 per cent since the beginning of 1981.

9. The Japanese argue with some justification that high US interest rates have been the main factor in the yen's weakness. Their own policies, however, have not helped. While interest rates have been brought down to stimulate domestic demand, the government's practice of controlling bank deposit rates and force-selling its own bonds at fixed prices to a syndicate of domestic banks has helped keep rates artificially low. The Japanese banks, however, have recently been refusing to buy more bonds and the government has been forced to allow long-term yields to reflect more closely market rates. The Bank of Japan has also operated in the money markets to push up short-term rates. We must hope that the recent fall in US interest rates, coupled with this firming of Japanese interest rates, will help the yen to appreciate. We should encourage the Japanese not to hinder this process.

10. The Japanese could also help the yen to become a firm currency in the longer term by allowing its reserve role to develop. At present, the yen accounts for only about 4 per cent of international currency reserves, slightly greater than sterling but well below the DM at 13 per cent and the dollar at 71 per cent. Greater availability of short term yen financial assets would tend to encourage foreigners to hold more yen in their portfolios.

Greater use of the yen in denominating international trade might also stimulate companies to increase their yen holdings. This would help to encourage Japan to play a full and responsible role in the international financial system, commensurate with the underlying strength of the economy.

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