DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

SM/83/36

CONTAINS CONFIDENTIAL
INFORMATION

February 18, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Japan - Staff Report for the 1982 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1982 Article IV consultation with Japan.

This subject has been tentatively scheduled for discussion on Friday, March 18, 1983.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

JAPAN

Staff Report--1982 Article IV Consultation

Prepared by the Staff Representatives for the 1982 Consultation with Japan 1/

Approved by P.R. Narvekar and Manuel Guitian

February 18, 1983

I. Introduction

The Japanese economy continues to perform well by comparison with other industrial countries. Growth in the past few years has been slow by historical standards, but the economy has probably operated nearer to its estimated medium-term potential growth rate than have the economies of the other major industrial countries. Japan is more dependent on imported energy than are these other countries and, thereby, subject to more severe deflationary pressures from the adverse terms of trade impact of increased energy prices and, possibly, to more severe structural dislocations; nevertheless, the required adjustments to those higher prices have been proceeding relatively smoothly. Particularly after the second round of oil price increases in early 1979, adjustment was effected with relatively less wage/price distortion and, hence, less disruption to labor markets and a smaller loss of output than in other countries. However, private domestic demand has, since then, experienced a protracted period of weakness. Flexible fiscal policy has provided some support to domestic activity during the weaker phases of the cycle in private demand and, until the past year, foreign trade developments also provided substantial additional support for growth.

1/ Consultation discussions were held in Tokyo from November 24-December 3, 1982 with officials of the Ministries of Finance and International Trade and Industry, the Economic Planning Agency, and the Bank of Japan. Follow-up discussions on the budget and the official forecast for 1983/84 (fiscal year beginning April 1) were held during January 17-19, 1983. The staff team comprised Messrs. Narvekar, Boorman and Hides, Ms. Schadler, Mr. Kashiwagi, Ms. Eken, Miss Sudo and Mrs. Owen. Mr. Hirao, Executive Director for Japan, attended the meetings as an observer.

The contribution which the foreign sector had made to the growth of the economy in 1980 and during much of 1981 was abruptly withdrawn in late 1981 to be replaced by a strengthening but erratic pattern of domestic demand. Sharply declining exports were accompanied through much of 1982 by exceptionally large net capital outflows and the yen weakened almost continuously before recovering markedly over the past three months. Combined with recessionary conditions in many partner countries, the weak yen encouraged further protectionist reactions against Japanese exports. Partly in response to the pressures which emerged from these developments, the authorities have on three occasions in the last 12 months announced measures to open further the domestic market to imported goods.

With the possibility of reducing interest rates largely forestalled by exchange rate considerations, the burden on fiscal policy remained especially heavy in 1982. This has thwarted the medium-term goal of eliminating by 1984/85 the issuance of deficit financing bonds to cover current expenditure. It has also led to an unprecedented increase in government debt outstanding and in debt service payments in the budget. The authorities are in the process of examining the medium-term economic and financial outlook for the economy, one important element of which will be a revised program to deal with the large and persistent fiscal imbalance. As an initial step in this process, the budget for 1983/84 projects some reduction in the deficit of the general account to be realized primarily through an austerity in government expenditures that is unprecedented in over 25 years.

The next section of this paper presents a longer-term review of developments in the Japanese economy. More recent developments are described in Section III, which is followed by a report on policy discussions with the authorities. Section V contains the staff appraisal.

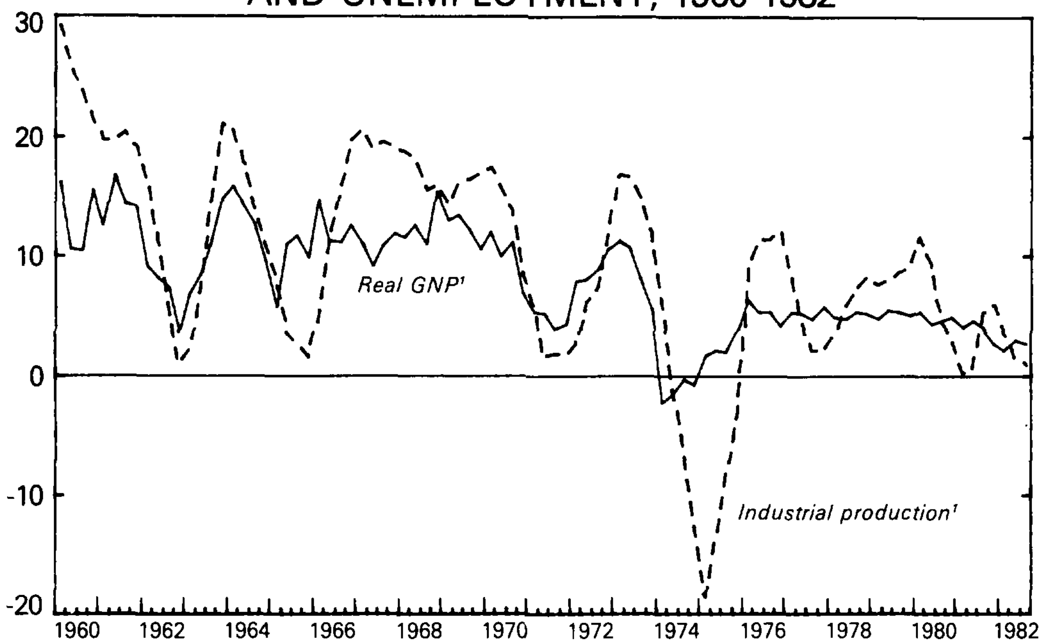
II. A Retrospective

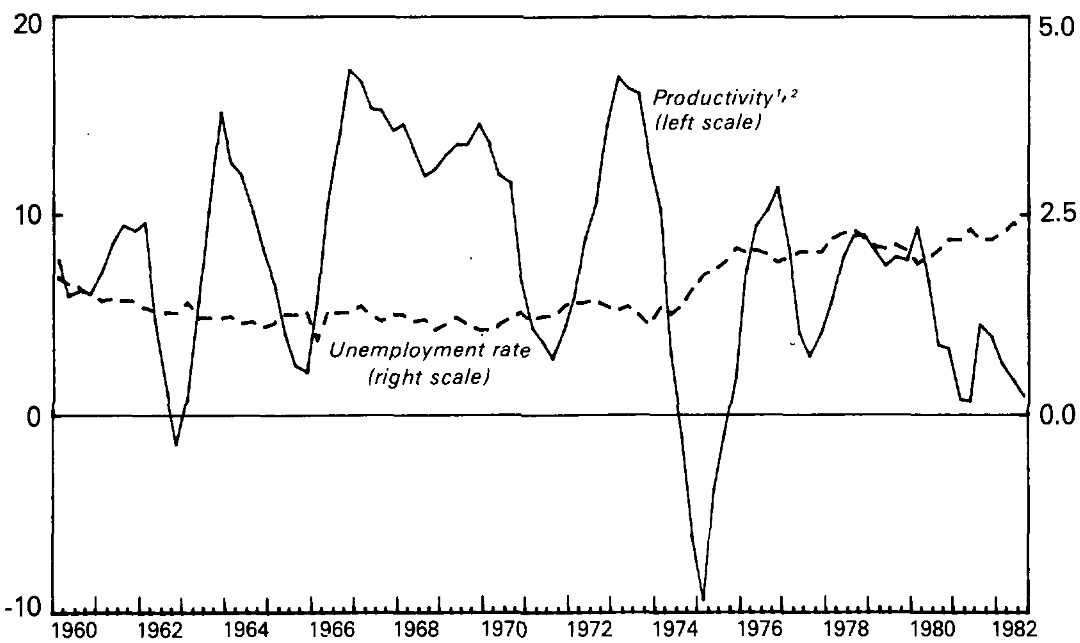
The performance of the Japanese economy during the 1960s is often cited as a model. Real GNP and industrial production grew over the decade at average annual rates of about 11 per cent and 15 per cent, respectively; productivity increased annually by over 9 per cent (Chart 1). Employment grew rapidly and by the end of the decade unemployment had been reduced to only 1.1 per cent of the labor force. Inflation was relatively moderate, with consumer prices increasing by just over 5 per cent per year (Chart 2). Government expenditure accounted for about 19 per cent of GNP in 1970, and, by international standards, an unusually high proportion of public spending represented investment expenditure. Various measures of social well being showed a marked improvement: life expectancy increased, working hours were reduced, and the proportion of the population completing secondary school and university increased substantially.

CHART 1

JAPAN

LONG-TERM TRENDS IN OUTPUT, PRODUCTIVITY AND UNEMPLOYMENT, 1960-1982



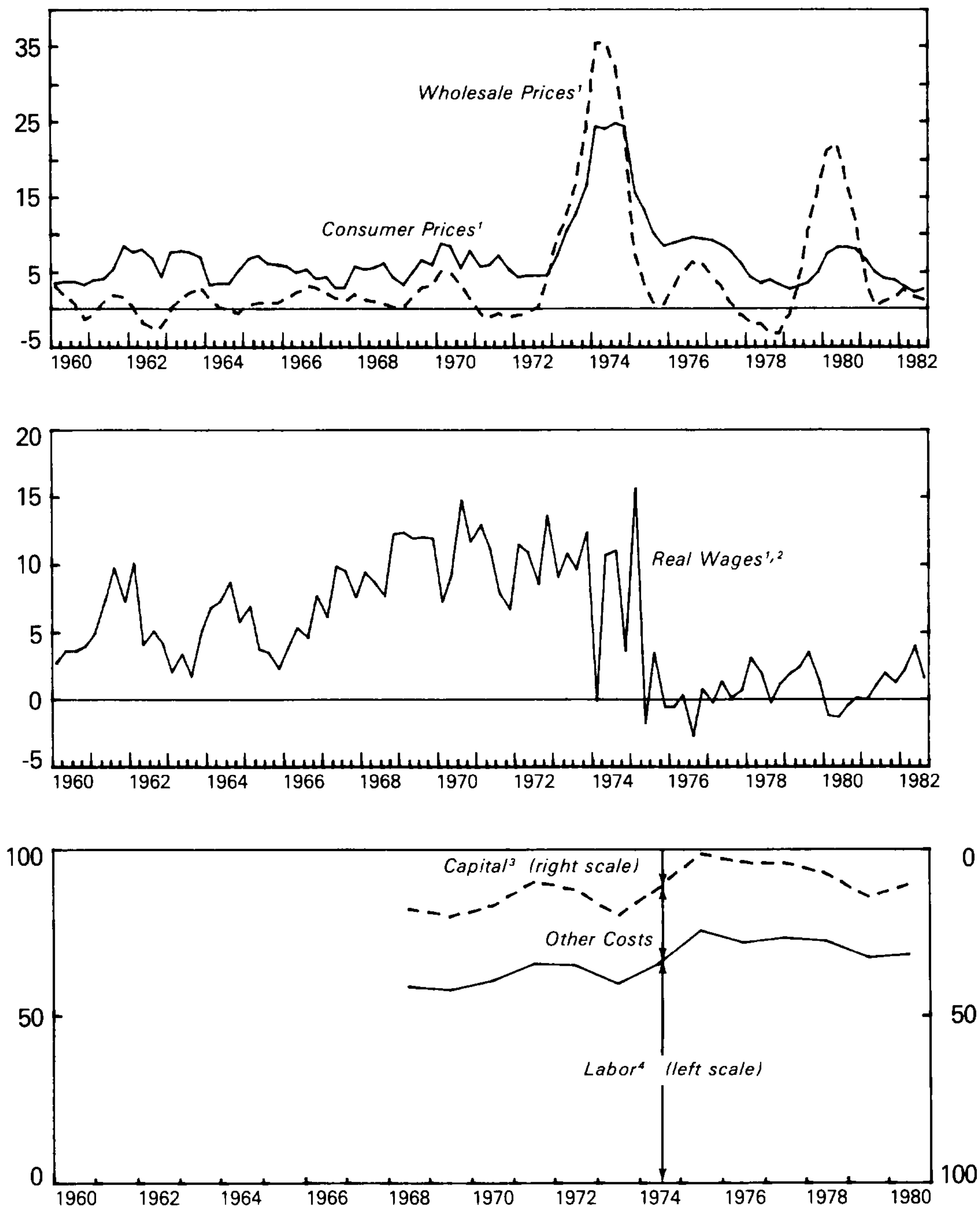


Sources: Bank of Japan, *Economic Statistics Monthly;* IMF, Data Fund and staff calculations.
[1]Percentage change since same quarter of previous year.
[2]Based on manufacturing output of regular workers.

CHART 2

JAPAN

LONG-TERM TRENDS IN PRICES, WAGES, AND INCOME DISTRIBUTION, 1960-82



Sources: IMF, *IFS*; Bank of Japan, *Economic Statistics Monthly*; Ministry of Finance, *Annual Financial Statements of Incorporated Business*

[1]Percentage change since same quarter of previous year.

[2]Hourly compensation/CPI.

[3]Business profits/value added, in per cent.

[4]Employee's compensation/value added, in per cent.

In the 1970s progress slowed from its exceptional pace in the previous decade. Some of the changes resulted simply from the maturing of the economy: more resources were devoted to the less efficient services sector and to social welfare, anti-pollution, and other activities which improve the quality of life but may not be captured in measures of economic performance. At the same time, other changes affected the performance of industry. First, as a result of the rapid growth of the 1960s, labor constraints began to emerge, especially as the scope for additional movement of labor from the rural agricultural sector to the manufacturing sector was reduced. These constraints contributed to an acceleration of real wages in the late 1960s and early 1970s. Second, following the rapid implementation of known technology during the 1960s, Japanese industry was largely on a par with industries abroad and opportunities for borrowing technology declined. Finally, the oil price increases caused significant deterioration in the terms of trade and a sharp change in the relative price structure of the economy. High cost energy lowered efficient output levels and made obsolete a significant portion of the productive capital stock, particularly in processing industries. As a result, labor productivity, which fell for two years in a row following the first oil price increase, never fully recovered to the levels recorded in the 1960s, growing only slowly during the rest of the decade (Chart 1).

The increase in real wages through the mid-1970s and the decline in productivity raised unit labor costs and increased labor's share of value-added in manufacturing, largely at the expense of profits (Chart 2). The associated decline in profitability, together with unprecedented domestic inflation, uncertain prospects for both domestic and foreign demand, and volatility of exchange rates, made investment planning unusually difficult. Although wages increased only moderately and profitability improved gradually during the latter half of the 1970s, it was not until mid-1978 that private domestic investment showed signs of strong recovery from the impact of the dislocations which had occurred earlier in the decade.

Japan has adjusted relatively well to the significant changes which have buffeted the economy since the early 1970s. Particularly after the second round of oil price increases, this adjustment was facilitated by the timely adoption of policies which helped retard the spillover of the initial price distortions to other cost/price relationships in the economy; the structure of various Japanese institutions, especially the country's labor market arrangements and the general absence of indexation, assisted this process. Notwithstanding this relatively successful adjustment, the oil price increases, combined with the other developments adversely affecting the economy over this period, still took a heavy toll. Growth in the 1970s averaged 5.4 per cent per year, less than half that recorded in the previous decade; private plant and equipment investment as a share of GNP fell from 27 per cent on average in the 1960s to 22 per cent during 1975-80; the unemployment rate increased to 2.1 per cent; productivity growth slowed to less than 7 per cent; and inflation at the consumer price level averaged 9 per cent per year.

One result of the developments of the 1970s was a sharp increase in the size of the Government. Government expenditure grew rapidly as a result of efforts both to adjust the social infrastructure, including the social welfare system, to the higher income level reached in the early 1970s, and to ensure fuller utilization of the continued large flows of private savings in the face of weak private investment demand. The slowdown in economic growth during the 1970s retarded the growth of tax revenue, which then failed to match the dynamics that had been set in motion in government expenditure. Between 1970 and 1980, government spending (including transfer payments) as a share of GNP increased by 13 percentage points to almost 33 per cent; the overall position of the general government shifted from near balance in the late 1960s and early 1970s to a persistent deficit of about 4 per cent of GNP after the mid-1970s (Chart 3, top panel). Deficits of the Central Government were even larger (Chart 3, bottom panel).

III. The Recent Past

As the inflationary impact of the second round of oil price increases abated and the terms of trade stabilized, activity in the private sector was expected to recover and, in late 1981, the authorities projected that economic growth above 5 per cent would resume in 1982. These expectations were frustrated, however, largely because of the sluggish response of domestic demand to these improved conditions as well as of the slowdown in worldwide economic activity. As a result, growth is now expected to be only slightly above 3 per cent in the fiscal year ending March 1983, somewhat below the 3.3 per cent recorded in the previous fiscal year. This section focuses on the developments underlying this performance.

The growth of final private domestic demand declined sharply with the onset of the second round of oil price increases and virtually ceased from mid-1979 until late 1981. The private domestic economy was weakened to begin with by the deflationary effects of the oil price increases, then by the tight monetary policy introduced early in 1979 to dampen the inflationary impact of both these external price increases and the subsequent depreciation of the yen, and, finally, the structural weakness of certain sectors, such as residential construction. A decumulation of inventories throughout this period further depressed activity. At the same time, under the impetus of sharply improved competitiveness, partly resulting from the depreciation of the yen from late 1978 to early 1980, net foreign demand grew strongly, accounting for almost two thirds of the growth of GNP, which averaged over 4 per cent per year. Particularly during the latter part of the period, government spending accounted for much of the rest of the expansion of the economy.

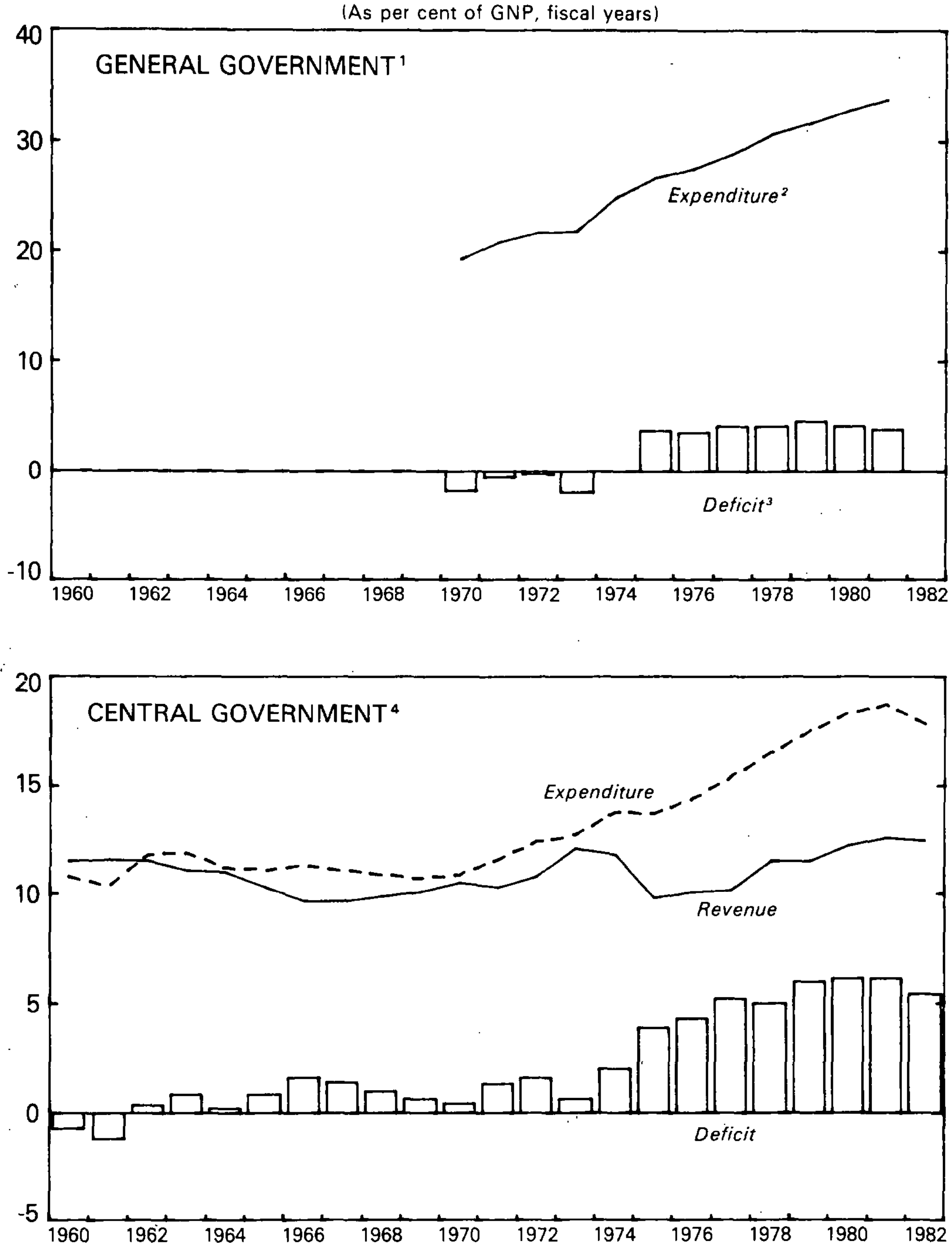
The support provided to the economy from the external sector was abruptly withdrawn in the last quarter of 1981 when exports fell by almost 4 per cent in volume from their level in the previous quarter. Notwithstanding some recovery of private domestic activity during this period, weak external demand, combined with a decline in public investment, led to a drop in GNP of over 1 per cent.

CHART 3

JAPAN

LONG-TERM TRENDS IN GOVERNMENT ACCOUNTS, 1960-82

(As per cent of GNP, fiscal years)



Sources: Japan, Economic Planning Agency, *Annual Report on National Accounts*, 1982; Ministry of Finance, *Zaisei Tokei*, 1982/83 (fiscal statistics).

[1]Consistent data for the period before 1970 is not available.

[2]Sum of current disbursements, net capital transfers paid, gross capital formation and net purchase of land less consumption of capital.

[3]Current receipts less total disbursements.

[4]General Account of the Central Government.

The decline in GNP in late 1981 was short-lived, however. Under the impetus of increasing real disposable income, as well as the successful rebuilding of real financial assets which had been depleted by the surge in prices in 1979 and 1980, and some special (partly seasonal) factors, consumer spending rebounded sharply during the first two quarters of 1982, increasing on average at an annual rate of nearly 7 per cent. However, this pace of increase declined sharply to an annual rate of only about 1 per cent in the third quarter. After some weakness in the first quarter of the year, reflecting a decline in public works expenditures, government spending expanded briskly, providing an important element of strength to the domestic economy.

Most other spending remained relatively weak in 1982. Plant and equipment investment, which lost momentum during 1980 and 1981, was virtually flat during the first three quarters of 1982. Investment by large firms remained relatively strong until very recently, despite the weakening of domestic demand. The steady pace of replacement and energy and labor saving investments--which tend to be relatively sensitive to the rate of profit--kept capital spending by large firms relatively buoyant. The heavy export orientation of those firms, particularly in the manufacturing sector, also contributed to the strength of their investment. In contrast, investment by small- and medium-sized firms--which accounts for over half of total investment and tends to be more heavily affected by prospects for domestic demand, capacity utilization and interest rates--has been weak. This pattern of overall investment has persisted through the end of 1982, although the growth of investment by large firms has subsided somewhat in the face of the sharp decline in world demand, weakening sales and profits, excess capacity, and protectionist actions against Japanese exports. Residential investment increased during the second and third quarters of 1982. However, this was due mostly to temporary factors, and the declining trend of the last two and one-half years appeared to be unchanged. Net foreign demand has contributed little to growth since late 1981.

This uneven sectoral performance resulted in GNP growth at an average annual rate of 4 per cent during the first three quarters of the year; in the third quarter GNP was 2.7 per cent above its year earlier level. Inflation continued to moderate over most of 1982 despite the almost continuous depreciation of the yen, and by the fourth quarter, consumer and wholesale prices were only 2.4 and 1.6 per cent, respectively, above their year earlier levels. Prices of domestic goods were virtually unchanged during this period.

Indicators other than national accounts suggest a somewhat greater degree of weakness in the domestic economy, particularly in the production sector. Inventory adjustment, especially of manufactured goods for export, has been a problem throughout the year, extending the raw materials and domestic goods inventory cycle which appeared to have been mostly completed by late 1981. Industrial production has been generally weak and has averaged only about 1 per cent above its year earlier levels in the months since April; the operating ratio in the manufacturing sector has moved downward erratically during 1982, and during the last months of the year stood at about 10 per cent below the peak level reached during 1980. Nevertheless, the number of unemployed has increased only moderately--to about 2.5 per cent of the labor force. Although these developments represent a marked deterioration from the economy's earlier performance, the situation could have been worse without the continued moderation of wage increases. Nominal wages in the manufacturing sector are estimated to have increased by about 5.5 per cent in 1982 and real wages by less than 3 per cent. With only a small increase in productivity, unit labor costs rose by about 4 per cent. Profits--particularly among domestic-oriented small- and medium-sized firms and in raw materials processing industries--have been generally weak.

Exports (on a customs clearance basis) have declined steadily throughout the past year, under the impact of the prolonged weakness in Japan's major overseas markets, the substantial accumulation of both domestic and overseas stocks of Japanese exports, the loss of competitiveness resulting from the substantial appreciation of the yen vis-a-vis European currencies during 1980 and 1981, and voluntary restraint schemes affecting the export of some important products. Imports have also declined almost continuously, but at a slower pace, reflecting both sluggish domestic demand and continued success in energy conservation (Chart 4). In sum, the substantial widening of the current account surplus that was expected did not materialize and a surplus of $6.9 billion was recorded in 1982, as compared to $4.8 billion during 1981.

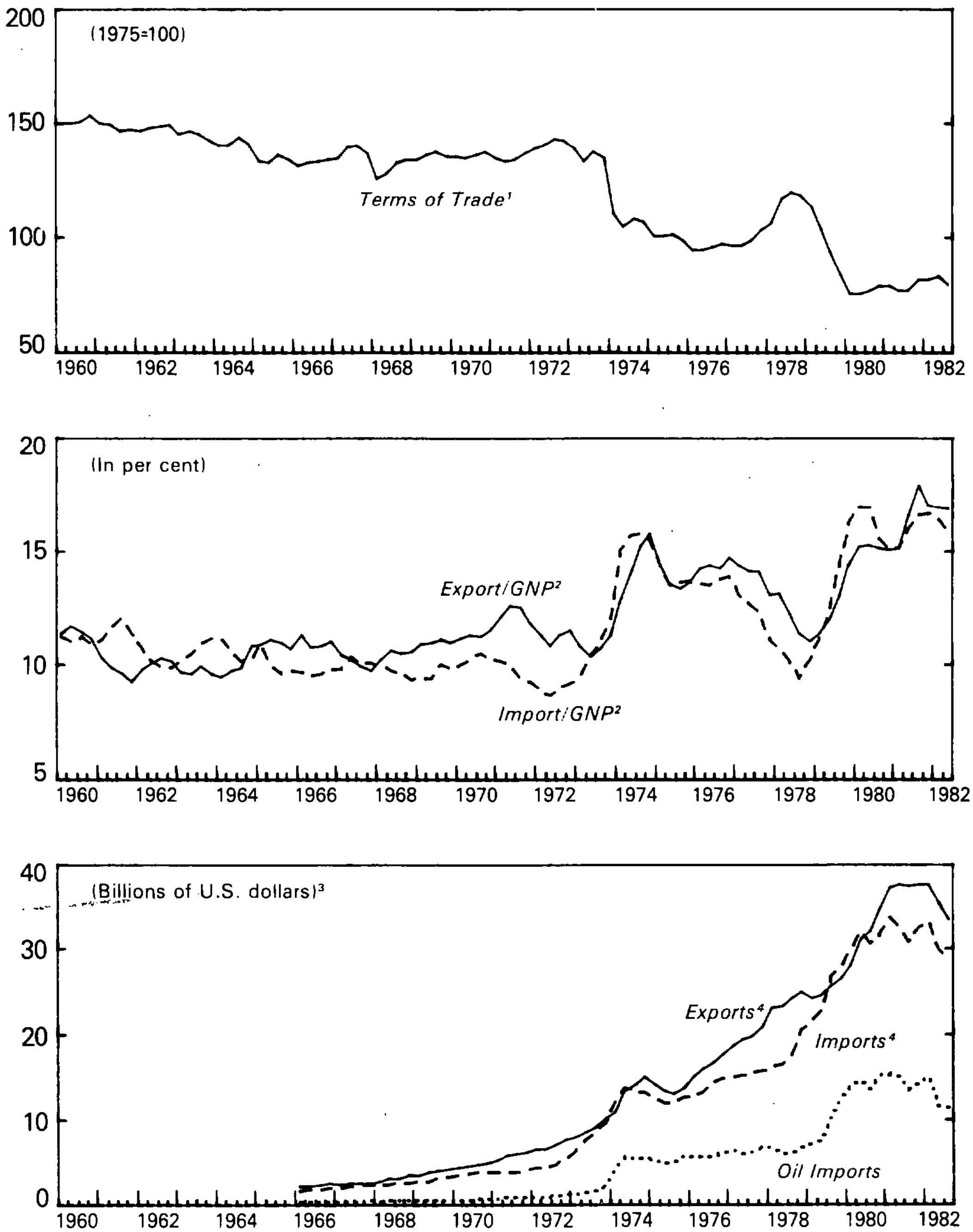
The most troubling development during 1982 was the almost continuous weakening of the yen which occurred until early November (Table 1 and Chart 5). Whereas the yen had maintained its strength against most currencies other than the dollar during 1981, its weakness throughout 1982 was more pervasive. From its peak level in November 1981, it depreciated against the dollar and in effective terms by 23 per cent and 15 per cent, respectively, over the period to end-October 1982. This pattern of movement in the exchange rate, combined with only a moderate rise in unit labor costs, led to an almost steady improvement in Japan's competitive position between early 1981 and the third quarter of 1982 (Chart 6). Differential movements in measures based on unit labor costs and export unit values suggest, however, that some of the potential gains from the exchange rate movement were taken as profits by exporters rather than as increased shipments, partly, perhaps, in response to the threat of protectionist measures on the volume of exports. The rebound in the exchange rate since early November has erased much of the depreciation against the U.S. dollar which occurred earlier in 1982 and restored the value of the yen against other currencies to values at or above the levels prevailing in late 1981.

The weakness of the yen throughout most of 1982 was associated with unusually large net outflows of long-term capital. In particular, foreign inflows of funds to the Japanese securities markets, which had increased substantially in 1980 and 1981, slowed dramatically in the first quarter of the year and remained at relatively low levels until September. Since then, with the sharp movement in nominal interest rate differentials in

CHART 4

JAPAN

LONG-TERM TRENDS IN FOREIGN SECTOR, 1960-82



Sources: IMF, *International Financial Statistics*. Francs.

[1]Export unit value/import unit value.

[2]Exports and imports of goods and services (national accounts data).

[3]Seasonally adjusted quarterly data.

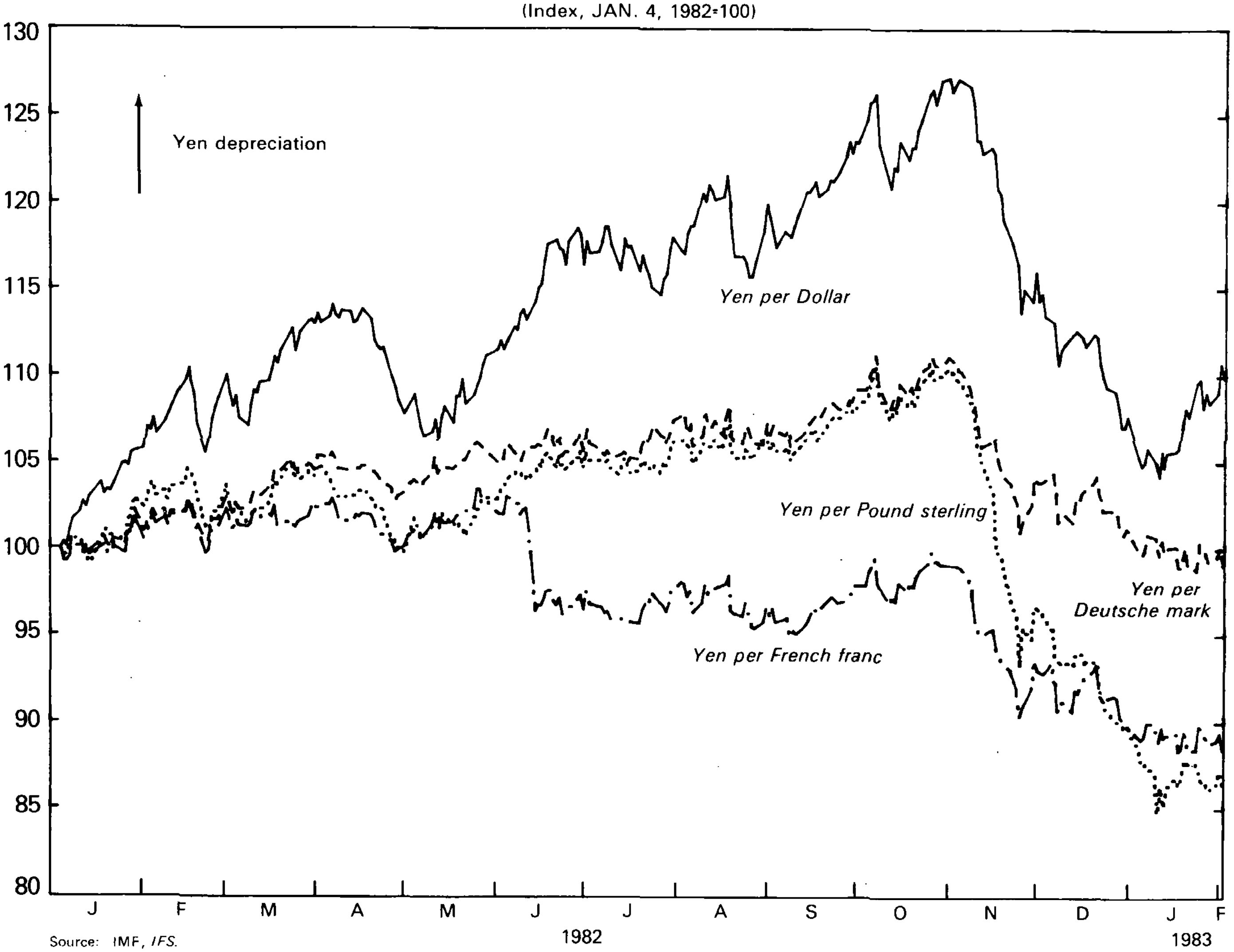
[4]Exports and imports include only merchandise; a large net deficit is generally registered on the services and transfers account.

CHART 5

JAPAN

DAILY EXCHANGE RATES: YEN VS. DOLLAR, DEUTSCHE MARK, FRENCH FRANC, AND POUND STERLING, JAN. 1, 1982 TO FEB. 2, 1983

(Index, JAN. 4, 1982=100)



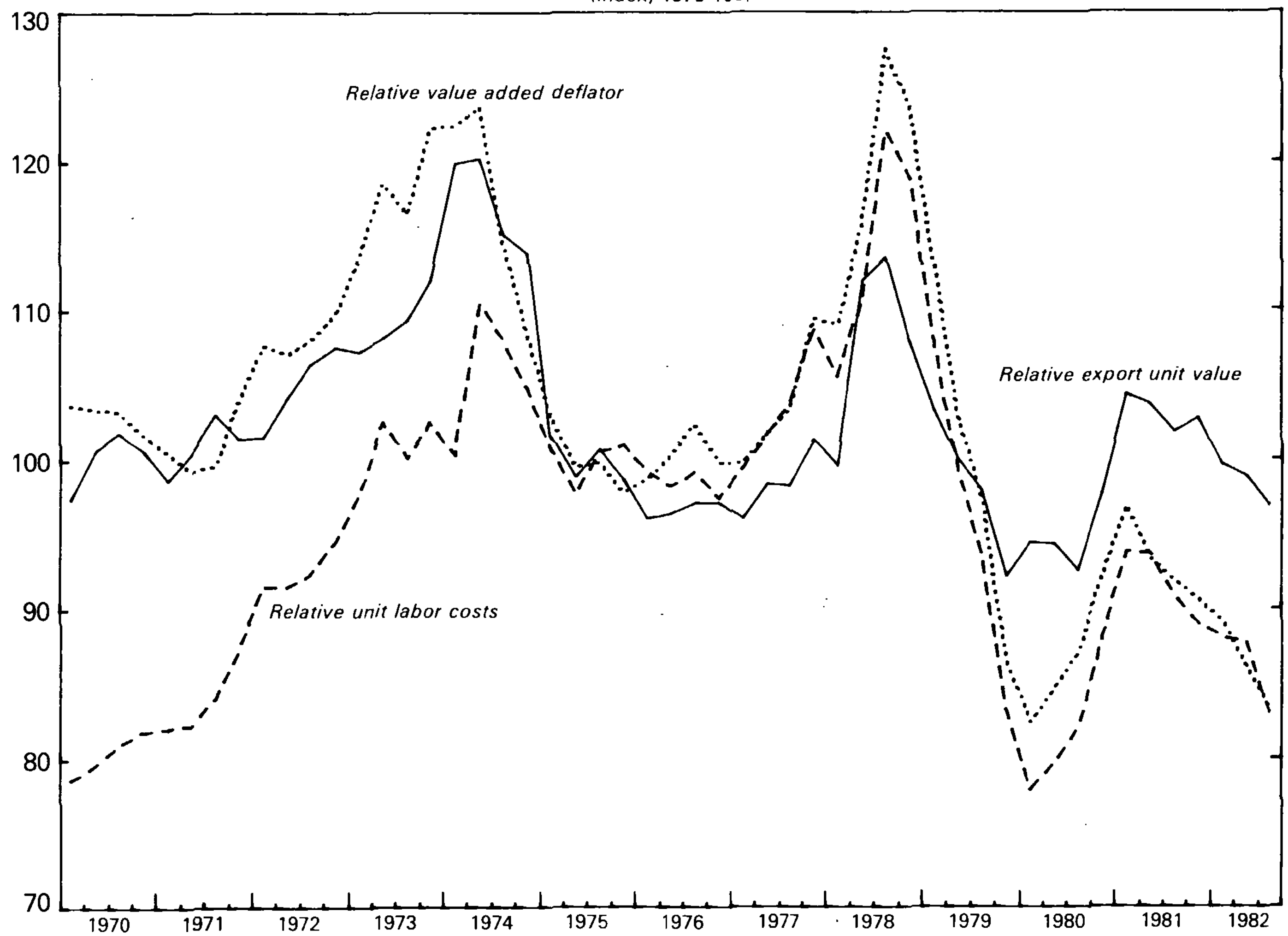
Source: IMF, *IFS*.

CHART 6

JAPAN

INDICATORS OF COMPETITIVENESS, 1970 - Q3 1982[1,2]

(Index, 1975=100)



Source: IMF, *International Financial Statistics*.

[1]An increase/decrease in the indices is indicative of a worsening/improvement in Japan's international competitiveness.

[2]Between the third quarter of 1982 the last period for which these data are available--and end-January 1983, the yen appreciated in nominal effective terms by 11.0 per cent.

Table 1. Japan: The Exchange Rate of the Yen and International Reserves, October 1978-January 1983

(End of period) 1/

	Exchange Rates							
	¥/US$	¥/DM	¥/FF	¥/£	¥/Sw F	MERM (1975=100)	Real effective rate 2/ (1975=100)	International Reserves (US$ bn.) 3/
October 1978	176.0	101.3	44.1	367.8	119.4	159.5	113.6 4/	29.6
1980								
March	249.7	128.6	55.8	541.0	136.3	118.3	94.4	18.9
December	203.0	103.6	45.0	484.2	115.1	144.5	97.6	25.7
December 1981	219.9	97.5	38.3	419.6	122.3	145.0	102.8	29.2
1982								
March	246.5	102.1	39.5	439.2	127.4	134.4	99.7	28.1
June	254.0	103.3	37.2	441.5	120.8	133.0	98.9	26.4
September	269.4	106.6	37.7	456.2	124.3	127.3	96.9	24.9
October	277.3	108.1	38.2	464.4	125.2	125.2	...	23.8
November	253.1	101.8	36.1	408.0	118.4	136.1	...	23.9
December	235.0	98.9	34.9	379.4	117.8	144.9	...	24.3
January 1983	237.9	97.2	34.3	364.2	119.0	144.9	...	24.6
Percentage change between (- = depreciation):								
October 1978 and March 1980	-29.5	-21.2	-21.0	-32.0	-12.4	-25.8	-16.9 5/	
March 1980 and December 1980	23.0	24.1	24.0	11.7	18.4	22.1	3.3	
December 1980 and December 1981	-7.7	6.3	17.5	15.4	-5.9	0.3	5.3	
December 1981 and October 1982	-20.7	-9.8	0.3	-9.6	-2.3	-13.7	...	
October 1982 and December 1982	18.0	9.3	9.5	22.4	6.3	15.7	...	
December 1982 and January 1983	-1.2	1.7	1.7	4.2	-1.0	--	...	

Source: IMF, International Financial Statistics.
1/ Calculated using representative rates.
2/ Relative manufacturing export unit values. Quarterly average data for quarter ending in the month specified.
3/ Including gold (national valuation).
4/ Average for the third quarter of 1978.
5/ Change between Qtr. 3, 1978 and Qtr. 1, 1980.

favor of Japanese assets and following the earlier sharp advance in the U.S. stock market--which often is followed by a similar rise in the Tokyo market--there has been renewed foreign interest in Japanese securities. Especially earlier in the year, there were exceptionally large purchases of foreign securities--bonds, in particular--by Japanese investors. Again, these flows slowed substantially after August.

IV. Report on Policies

Following the successful containment by mid-1980 of the inflationary impact of the second round of oil price increases, economic policy has been directed towards three major goals: restoration of steady, noninflationary expansion of the private domestic economy; reduction of the large fiscal deficits which had emerged in the mid- and late 1970s; and continuation of the successful structural adjustment strategies begun in the period between the energy price increases. Growth was to be restored primarily through the establishment of the appropriate financial environment to facilitate and encourage private sector activity. This was seen to encompass an easing of monetary policy--including a reduction of interest rates; restoration of a sound fiscal position--including administrative reform of the government sector, reduced growth of public expenditures, avoidance of major tax increases, and lower deficits; and continued moderate strengthening of the yen, reflecting relatively low domestic inflation and steadily improving fundamentals of the economy.

On almost all fronts, policy strategies have been frustrated and established goals have proved elusive. Adverse conditions in the world economy have played an important role in forcing an alteration of policy settings; unexpected weaknesses in certain domestic sectors have aggravated the situation; and the persistent weakness of the yen is viewed by the authorities as having had a primarily detrimental impact on the economy. In these circumstances, policy evolved rather differently during 1982 than was expected at the time of last year's consultation.

1. Fiscal policy in the recent past

In 1979, faced with unprecedented budgetary deficits--reaching 6.4 per cent of GNP for the Central Government--the authorities believed that action to reduce the size of those deficits was necessary if flexibility were to be restored to fiscal policy; if the private sector were not to be squeezed out of the financial markets as the expected recovery gained momentum; and if the budget were to be prepared for the inevitable increase in social spending which would accompany the projected rapid aging of the population later in this decade. Consequently, with the 1980/81 budget, the authorities announced a medium-term financial plan to eliminate the issuance of deficit financing bonds by the Central Government by 1984/85.1/ This was to be

1/ Deficit financing bonds are issued to cover expenditures other than on public works projects, which are financed by so-called construction bonds. By law, deficit financing bonds are to be redeemed "in cash" at maturity. Such bonds were first issued in 1975 with 10-year maturity. In 1979/80, deficit financing bond issues totaled ¥ 6.3 trillion, or 2.9 per cent of GNP.

accomplished without a major tax increase and was to be accompanied by a major reform of the Government's administrative structure, including a reduction in the size of the bureaucracy. The initial budgets for 1981/82 and 1982/83 called for reductions in the issuance of deficit financing bonds of ¥ 2 trillion and ¥ 1.6 trillion, respectively, bringing such issues to about half the level of 1979/80 (Table 2).

In the event, the authorities have encountered severe conflicts between these medium-term objectives and their more immediate desire to counter the weakness of the domestic economy which has militated against any substantial reduction in fiscal deficits; consequently, virtually no reduction in the issuance of deficit financing bonds has been possible (Table 2). Central Government deficits of about 6 per cent of GNP were recorded in 1980/81 and 1981/82 and for 1982/83 the deficit is estimated to amount to about 5.5 per cent of GNP. Although the growth of expenditure in 1981/82 was limited to 8.1 per cent--only slightly above the increase in nominal income--it was accompanied by a revenue shortfall, much of it reflecting lower than projected receipts of corporate income taxes, of ¥ 3.1 trillion or 10 per cent of projected revenue. This shortfall was accommodated primarily through transfers to the Central Government of funds secured through sales to the Bank of Japan of securities held by the Government's sinking fund.

In 1982/83, even with the increased public works expenditures incorporated into a supplementary budget approved by the Cabinet in October 1982, expenditure growth was again successfully constrained. Nevertheless, the deficit has again exceeded planned levels primarily because of a ¥ 6.1 trillion revenue shortfall below the initial budget. This reflects lower revenue late in 1981/82 which reduced the estimated revenue base, as well as the fact that economic growth in 1982/83 is estimated to be substantially below the 5.2 per cent forecast underlying the budget. In addition to slower than expected growth, the authorities cited three major factors responsible for the disappointing performance of tax revenue: the sharp decline in corporate profits; the slow growth of excise tax receipts because of a shift in the pattern of consumer spending toward services which are generally untaxed by the Central Government; and increased tax avoidance as individuals are pushed by higher nominal incomes into higher marginal tax brackets.

In view of the sluggishness evident in the economy when implementing the 1982/83 budget, the authorities front-loaded substantially the contracting of public works expenditures of the Central Government and public enterprises. Under indications of continued weakness of private spending later in 1982, the Government, in October, announced an additional ¥ 2 trillion public works program to offset the reduction in public works which would have occurred in the second half of the fiscal year. The authorities indicated that the package of stimulus measures would have been larger if it were not for their concern over the impact of the enlarged fiscal deficit on financial markets and on interest rates. Nevertheless, the measures taken were viewed as sufficient to support a continued high level of public works spending. The package included, most importantly, public works and disaster reconstruction by both central and local governments and additional funds for housing loans by public financial institutions. The revised official forecast for GNP growth of 3.1 per cent for fiscal 1982 incorporates the estimated impact of these measures (Table 3).

Table 2. Japan: Central Government General Account Budget, 1980/81-1983/84

(In billions of yen)

	1980/81	1981/82		1982/83		1983/84
	Settlement	Initial	Settlement	Initial	Revised	Proposed
I. Expenditures						
Social security	8,170	8,837	8,824	9,085	9,142	9,140
Education and science	4,606	4,742	4,822	4,864	4,833	4,819
Defense	2,250	2,400	2,441	2,586	2,567	2,754
Official aid	368	425	393	471	475	504
Energy	423	499	496	563	559	598
Others	7,371	7,809	7,509	7,990	7,822	7,792
Subtotal 1	23,188	24,712	24,485	25,559	25,398	25,607
Public works	6,896	6,655	7,085	6,655	7,281	6,655
Subtotal 2	30,084	31,367	31,570	32,214	32,679	32,262
Transfers to local government	7,829	8,767	8,697	9,637	7,976	7,673
Subtotal 3	37,913	40,134	40,267	41,851	40,655	39,935
Debt service	5,492	6,654	6,654	7,830	6,907	8,192
Of which: Transfer to sinking fund	715	947	947	1,198	--	--
Total (A)	43,405	46,788	46,921	49,681	47,562	48,127
II. Receipts						
Tax and stamp duties	26,869	32,284	28,952	36,624	30,478	32,315
Profits, etc.	2,012	2,027	2,261	2,376	2,498	2,896
Subtotal 1 (B)	28,881	34,511	31,413	39,000	32,976	35,211
Sale of financial assets 1/	--	--	--	200	200	1,822
Total	28,881	34,511	31,413	39,200	33,176	37,033
III. Deficit (B)-(A)	-14,524	-12,277	-15,508 2/	-10,681	-14,586	-12,916
Bond issues	14,170	12,270	12,900	10,440	14,345	13,345 3/
Deficit financing bonds	7,215	5,485	5,860	3,924	7,309	6,980
Construction bonds	6,955	6,785	7,040	6,516	7,036	6,365
(Deficit as per cent of GNP)	6.0	4.8	6.1	4.0	5.5	4.6

Source: Staff calculation based on data provided by the Japanese authorities.

1/ Includes drawdown of funds from the coin reserve fund, reserve fund for the mandatory automobile insurance scheme and the foreign exchange reserve fund. Since the assets of these reserve funds are invested by the Trust Fund Bureau, drawing down the funds could imply the sale of government bonds held by the Trust Fund Bureau.

2/ Includes borrowings from the sinking fund amounting to ¥ 2.25 trillion.

3/ Includes bond issues to finance the repayment to the sinking fund amounting to ¥ 2.25 trillion.

Table 3. Japan: GNP, Price, and Balance of Payments Projections, 1982/83-1983/84

	Staff Projections		Official Projections	
	1982/83	1983/84	1982/83	1983/84
Aggregate demand (In real terms, percentage changes)				
GNP	3.0	2.7	3.1	3.4
Private final demand	3.3	3.1	3.5	3.6
Of which:				
Consumption	4.1	3.3	4.3	3.9
Housing	0.1	2.0	0.5	2.6
Plant and equipment	2.0	2.9	2.0	2.9
Government final demand	2.5	-0.7	3.3	-0.7
Private inventory 1/	-0.3	0.1	-0.2	0.2
Foreign balance 1/	0.2	0.4	0.1	0.6
Prices				
Consumer prices	2.6	2.6	2.7	3.3
Wholesale prices	1.6	1.1	1.6	1.1
GNP deflator	2.0	2.2	2.0	2.2
Balance of payments (In bn. of US$)				
Exports	136.0	150.0	136.0	141.0
Imports	-117.0	-124.0	-117.0	-121.0
Of which: Oil (volume increase)	(-8.0)	(-3.0)	(...)	(...)
Trade balance	19.0	26.0	19.0	20.0
Services and transfers	-11.0	-12.0	-12.0	-11.0
Current balance	8.0	14.0	7.0	9.0
(Per cent of GNP)	(0.8)	(1.2)	(0.7)	(0.8)

Sources: Data provided by the Japanese authorities and staff estimates.

1/ Contribution to GNP.

The revised budget for 1982/83 indicates an increase in the Central Government deficit from a planned level of ¥ 10.7 trillion to ¥ 14.6 trillion, or from 4.0 to 5.5 per cent of GNP. Moreover, other measures taken by the authorities will increase deficit financed expenditures at various levels of government by more than an additional ¥ 3 trillion.1/

2. Prospects for the economy

For the next fiscal year, the authorities project GNP growth at 3.4 per cent (Table 3). Private consumption is expected to slow somewhat but all categories of private investment are expected to strengthen modestly and the external balance is expected to improve, making a moderate contribution to growth. The authorities expressed a high degree of confidence in the strengthening of the economy, pointing to an improvement in most of the fundamental factors operating in the economy which will work in favor of a recovery of private sector activity. The favorable factors cited by the authorities include the stabilization of inflation at a low rate; the appreciation of the yen; potential reductions in real interest rates as and when the yen strengthens further; and prospects for a modest recovery of world trade. With the expected improvement in the world economy, a reversal of the decline in exports is projected. However, increased domestic demand and somewhat higher raw material prices are expected to raise imports, leading to only a moderate increase in the current account surplus to about $9 billion.

The authorities note that domestic growth at about the forecast rate would represent performance at near the estimated potential growth rate of the economy. In view of the new price relationships in the economy, including the lower rate of return on capital and the higher cost of energy, and the other changes that have occurred over the past decade, the authorities estimate that the potential rate of growth has declined dramatically from its level of over 10 per cent during the 1960s. For example, the Economic Planning Agency (EPA), which revised downward its projected growth rate for the economy to about 6 per cent in the mid-1970s, has recently suggested that the economy can grow at an annual rate of only 4-5 per cent under the new circumstances; this view is supported by some private analysts. Ministry of Finance estimates suggest a somewhat sharper decline in the growth potential of the economy to a level nearer to 3 per cent. These differences reflect almost entirely different perceptions as to the contribution that technological progress can make to growth in the coming years.

1/ These measures include reduction of transfers of tax revenue to local governments amounting to ¥ 1.7 trillion which will be supplanted by additional lending to local governments by the Trust Fund totaling ¥ 1.5 trillion; suspension of transfers to the sinking fund by the general account of the Central Government of ¥ 1.2 trillion; and additional public works to be financed primarily by bond issues by local governments amounting to about ¥ 0.5 trillion.

The staff forecast for growth of the economy in the coming year is slightly lower than that of the authorities. This reflects primarily a somewhat slower recovery of consumer spending (Table 3). The relatively sharp decline in the saving ratio which has occurred in the past year may not continue at the same pace, suggesting a rise in consumer spending not much faster than the projected increase in real disposable income. The sluggish pace of activity in the last two quarters, the delay in recovery in the rest of the world, and the high degree of uncertainty as to the timing and strength of improvement in certain other factors--including the exchange rate--which are expected to increase activity, suggest great caution in projecting a strengthening recovery of private demand. The differences on this account are not large, however, and tend to diminish as the forecast period is extended. In the external sector, on the basis of the usual assumption of no change in the nominal effective exchange rate and recovery of the world economy at the pace projected in the recent WEO, the staff would see a somewhat stronger rebound of exports, leading to a larger increase in the current account surplus. This forecast presumes nearly stable oil prices; any significant decline in those prices would have a strong short-term impact on the current account.1/

3. The 1983/84 budget

The official economic forecast incorporates a decline in real expenditures by the Central Government and little if any increase by other units of government. This represents the most marked austerity since 1955. In the budget of the Central Government, expenditures on social security and education and science will remain at about the same level as in 1982/83; public works spending, at the same level as in last year's initial budget, will decline substantially from the revised figure; transfers to local governments will also fall (Table 2). Only debt service, defense, spending on energy programs, and foreign aid are slated to increase. With no major adjustments in the tax system, revenue is forecast to increase by 6 per cent, slightly above the projected growth rate of nominal income. The deficit of the general account is estimated to be ¥ 12.9 trillion, or 4.6 per cent of GNP, compared with an estimate of ¥ 14.6 trillion, or 5.5 per cent of GNP in 1982/83.2/ Deficit financing bond issues will total ¥ 7 trillion, slightly below those estimated for 1982/83. Reflecting the reduction in public works spending, construction bond issues will decline by a somewhat larger amount.3/

1/ A 10 per cent drop in the price of crude oil would reduce the oil import bill in the short run by about $5 billion per year.

2/ Certain adjustments which influence the financing of deficits in recent years are reflected in expenditure items in the official budget presentation. The deficit figures cited above are derived after adjustment to make revenue and expenditure accounts comparable across recent years. See the footnotes to Table 2 for the details of these adjustments.

3/ The 1983/84 budget incorporates a repayment of ¥ 2.3 trillion to the government sinking fund to replace borrowings made in 1981/82. However, it also reflects a drawdown of the coin reserve fund (¥ 1.1 trillion) and, as in the case of the 1982/83 revised budget, suspension of the annual transfer to the sinking fund (¥ 1.4 trillion).

In noting the restrictive nature of this budget, the authorities emphasized that they had nevertheless paid due consideration to the weak business situation: investments and public sector lending would be selected with a view to their contribution to growth; a proposal for accelerated depreciation for small- and medium-sized enterprises was included in the budget; and some tax incentives were to be provided to housing investment. In addition, the late approval by the Diet of the stimulus package approved in the supplementary budget for 1982/83 was thought likely to result in some carryover of spending into the early part of the next fiscal year.

The 1983/84 budget reflects the authorities' continued commitment to reduce the fiscal deficit over the medium term through control over the growth of expenditures, although the target for elimination of deficit bond issues by 1984/85--which would now require a reduction of the Central Government deficit by the equivalent of 2.5 per cent of GNP in one year--appears to have been effectively abandoned. A new approach to fiscal reconstruction is emerging in the new medium-term outlook currently in preparation. Rather than setting specific targets for the Government to achieve by certain dates, this approach will apparently focus on the issues that are involved in deficit reduction, expenditure control, tax structure and policy, and the provision of public services and the need to pay for them, in order to foster a national consensus on these subjects.

4. Monetary policy

In the first month of each quarter, the authorities announce a projection of the amount by which the average broad money stock for that quarter will exceed its level of a year earlier. This projection takes account of the lending plans of banks, capital flows and other factors likely to change the supply of money, as well as factors influencing the demand for money. While the authorities emphasize that this figure is merely a projection and not uniquely indicative of policy intentions, they note that such projections have been broadly consistent with policy intentions since they were first released in 1978. These projections presume certain actions on the part of the monetary authorities to guide monetary expansion toward the announced growth rate. Thus, there is a certain element of targeting in these projections, which can be seen, for example, in the way in which "window guidance" over the volume of lending by banks has at times been employed to help achieve monetary growth at the officially projected rate. The authorities emphasize, however, that the main mechanism of monetary control and the best indicator of policy intentions are movements in interest rates. "Window guidance" and other such devices are supplementary measures used mainly to increase the efficiency of the policy transmission mechanism.

The major objectives of monetary policy are the control over inflation and, to the extent that it is consistent with this objective, the maintenance of favorable conditions for the expansion of private domestic activity. At times, however, as in early 1980, again during 1982, and at present, exchange rate considerations have predominated in determining the stance of monetary policy.

Monetary policy was tightened substantially in early 1979 to counter the inflationary effects of the second round of oil price increases. Once that threat had abated and the weakness of the yen which followed those price increases had been reversed, policy was eased starting in August 1980 to encourage a recovery of private domestic demand. Both nominal and real interest rates declined steadily during the early part of this period, although some increase in real interest rates occurred in the second half of 1981 as inflation continued to fall and the decline in nominal interest rates was halted because of the renewed decline of the yen against the dollar. Over the period from the last quarter of 1980 to late 1981, the year-on-year growth rate of broad money increased from 7.8 per cent to 10.6 per cent.1/

The collapse of export growth in late 1981, along with the persistent weakness of domestic demand, suggested that increased priority be given to stimulating domestic activity in formulating monetary policy. The strengthening of the yen in late 1981 was viewed by the authorities as affording the opportunity to do so. Thus, in mid-December 1981, the official discount rate was reduced by 0.75 per cent to 5.5 per cent, and, a short time later, other administered interest rates were lowered. At the same time, the projection for monetary growth for the first quarter of 1982 was increased slightly to 11 per cent. The authorities explained that a growth rate for money for this period at the upper limit of the acceptable range had been seen as appropriate in view of the relatively slow recovery of economic activity. The actual growth of broad money was 10.6 per cent.

As events developed early in 1982, however, interest rates again increased overseas, provoking large net capital outflows and an effective depreciation of the yen of about 6 per cent between December and March. The authorities began to adjust policy to provide some additional support for the yen while minimizing the threat to what was viewed as only a weak recovery of domestic activity. In March, the Bank of Japan, through open market operations,2/ signaled the financial markets that the seasonal pattern of large Treasury disbursements would not be permitted to have the effect of increasing liquidity and reducing short-term interest rates; other action was taken at the same time to tighten money market conditions. As a result, short-term interest rates rose, albeit by only about three quarters of a per cent. At the same time, in view of the needs of the domestic economy, and in order to adjust to earlier declines in long-term market rates, administered long-term interest rates--including the subscriber yield on government bonds and the long-term prime lending rates--were reduced in April 1982. The growth of the broad money supply decelerated sharply in the second quarter of the year. However, the authorities explained that insofar as this resulted, in part, from the sale of Treasury

---

1/ The quarterly growth of money (seasonally-adjusted annual rates) increased from its trough of 4.8 per cent in the third quarter of 1980 to 11.7 per cent one year later.

2/ These operations included for the first time sales of Treasury bills by the Bank of Japan to the nonbank public.

bills to the nonbank public--which they consider to be close substitutes for certain types of bank deposits included in broad money--it overstated the intention of policy at that time.

Shortly after the tightening of policy began in March 1982, long-term market rates began to increase, and by June, rates on long-term government bonds were one full percentage point above their level in April. The authorities attribute this rise in long-term rates partly to arbitrage across the maturity spectrum, but, more importantly, to the psychological impact on the financial markets of the announced shortfall in government revenue in fiscal year 1981/82 and the associated enlarged financing needs of the government.

Whatever its causes, the increase in interest rates had the effect of temporarily reversing the depreciation of the yen. That pattern was short-lived, however, and in June 1982 the yen began to weaken again. As a result, the authorities considered additional measures to tighten monetary conditions, notwithstanding their desire to be more accommodative to the needs of the domestic economy. However, at the same time, U.S. interest rates began to decline. In the view of the authorities, it was primarily the large interest differential vis-a-vis the United States--and especially that with respect to rates on longer-term assets--that had led to the weakening of the yen. As the fundamentals of the Japanese economy remained sound, they expected a narrowing of the differential to reverse that weakness. Consequently, measures to further tighten monetary policy were not introduced. In the event, the yen continued to weaken until October.

Notwithstanding the weakening of the yen over the third quarter, broad money continued to increase at an annual rate of about 9 per cent. This represented a sharp acceleration of the annualized (seasonally adjusted) rate from 5 per cent in the second quarter to over 11 per cent in the September quarter. Part of this rise was the result of special factors, including the maturing of Treasury bills that had previously been sold to the public by the Bank of Japan. These instruments are viewed by the authorities as having much the same liquidity characteristics as some components of the broad money stock.1/ Partly as a result of this factor, the authorities do not attribute the weakness of the yen over this period to the increase in monetary growth. Indeed, interest rate movements over this period do provide somewhat different indications. Short-term rates remained stable between June and September, and certain administered rates had to be increased in September to bring them closer into line with market yields.

For the last quarter of 1982, the authorities projected monetary growth (year-on-year) of about 8 per cent and emphasized the continuous decline in the quarterly (year-on-year) growth rate which prevailed since early in the year. Notwithstanding the strong rebound in the yen from ¥ 278/US$1 in early November to about ¥ 235/US$1 by mid-January, an effective appreciation of 17 per cent, the authorities continued to emphasize the desirability

1/ The authorities explained that if such Treasury bill operations were to become a permanent feature of the system, the appropriate definition of the monetary aggregate may have to be adjusted to incorporate this factor.

of a still stronger yen. In this light, the monetary growth projection was reduced somewhat further for the first quarter of 1983 to 7-8 per cent. The authorities explained that this projected rate of monetary expansion was viewed as sufficiently accommodative not to thwart the forecast growth of the economy. The authorities again stated that despite the growing pressure from various segments of the domestic economy, the official discount rate would not be adjusted until a persistent firming trend of the yen was confidently perceived. While there had been some softening of interest rates between November and late January, both short-term and long-term rates were still at the levels that had prevailed in early 1982 and only about one half to three quarters of a percentage point below the peak level reached in mid-year. Thus, most of the substantial decline which had occurred in overseas rates since mid-1982 was reflected in a sharply narrower interest differential against the yen. Real interest rates remained at historically high levels, somewhat above the levels prevailing in the other major industrial countries.

5. The exchange rate

The authorities attributed the weakness of the yen during 1982--which brought it to a five year low against the U.S. dollar in early November (¥ 278/US$1)--primarily to the large interest differential which prevailed against yen assets during much of the year. They cited the interest differential as one of the primary factors behind the more than doubling of net long-term capital outflows during the first 9 months of 1982 from their level in the same period of 1981. With only relatively minor adjustments in nominal interest rates in Japan during this period, it was not until U.S. interest rates began to fall sharply after mid-year that the differential narrowed, eventually reducing net capital outflows. Other factors thought to have weakened the yen during this period were the sharp drop in Japanese exports and the consequent smaller than expected improvement in the current account. The formal and informal restrictions and "voluntary restraints" placed on Japanese exports may have aggravated this situation. The delay in the strengthening of the yen following the narrowing of interest differentials is attributed partly to the political uncertainties that may have been raised by the prospect of an election for Prime Minister in October and partly to the general strength of the dollar against all major currencies during that period. Since the yen began to strengthen in early November, it has appreciated by 17 per cent against the dollar and 15 per cent in effective terms. The authorities have very much welcomed this appreciation, seeing in it the removal of an emerging threat to price stability and the potential for improving the extremely weak profit situation in import processing industries and strengthening the tone of domestic financial markets. Notwithstanding the recent appreciation, however, at recent exchange rates for the yen, the competitive position of Japanese industry remains highly favorable--at near the levels prevailing during 1975-77.

During the course of 1982, the authorities intervened heavily at times to support the yen by selling dollars in the exchange markets to stabilize disorderly conditions in those markets and to signal the market as to their view that the yen was undervalued. Intervention in support of the yen amounted to over $8 billion between January and October; its effect on the domestic money stock was routinely sterilized by other actions of the Bank of Japan, however. The authorities noted that, while this intervention was sometimes effective in moderating the depreciation of the yen, that effectiveness was limited by the lack of participation by other monetary authorities. There was no intervention by the authorities to support the dollar after the yen began to strengthen in early November despite the sometimes large daily movements in the exchange rate. The authorities explained that their reluctance to intervene at that time reflected several considerations, including their desire to avoid any misunderstanding about their approval of the strengthening of the yen and their view that, in light of the excessive weakness which had developed, a strong and rapid reversal was not surprising.

6. Trade and capital market policies

In discussing the rising trend in protectionism, the authorities linked it to the weak state of the world economy and thought it was likely to be halted and reversed only after a recovery was evident. In the meantime, recognizing the political reality of protectionist sentiment, they stressed that whatever trade restrictive measures governments felt necessary to impose should at least be temporary and transparent so as to be more easily removed when the recovery comes.

At the present time, about 14 per cent of Japanese exports are subject to some kind of protectionist action or voluntary restraint, although the authorities noted that these measures restricted exports only in the case of a few items, including automobiles, color TVs and video recorders and only in specific markets. They feared, however, that even in the early phases of a recovery, particularly if employment should lag behind the rebound in spending, protectionist action in some of Japan's markets could persist. In principle, the Government would like to work toward a free trading system and felt that it should not impose export restraints. However, the authorities recognized that a heavy concentration of exports of specific items could cause problems in certain markets, and they were prepared to help avoid these situations.

During the course of 1982, the authorities took various measures to further open up domestic markets to imports.1/ As part of these measures, the Ministry of Finance had prepared for submission to the Diet a list of 228 items, accounting for about 9 per cent of non-oil imports, on which tariffs would be either substantially reduced or eliminated in April 1983. At the same time, quantitative restrictions on some of the 27 items still subject to such restraint would be eased. In early January 1983, the authorities took additional measures aimed at further opening the domestic market. These included actions to improve import testing and approval procedures; tariff reductions or eliminations on an additional 86 items; relaxation of import restrictions on certain agricultural products; and efforts to

1/ Details of these measures were reported in: "Japan: Recent Economic Developments" (SM/83/17, 1/26/83).

strengthen the effectiveness of the Office of Trade Ombudsman. In combination, these measures leave Japan with the lowest tariffs on imports of manufactured goods among the major industrial countries. Imports of such products, at least at the level of final consumer goods, are increasing faster than domestic expenditures. At the same time, however, protection of the agricultural sector, including through the imposition of quotas, remains considerable and domestic wholesale prices for certain products, including rice, wheat and beef, exceed world market levels by substantial margins.

The authorities pointed to their efforts at structural adjustment to divest the economy of capital in inefficient processing industries as progress toward the goal of encouraging the international division of labor. At the same time, however, they indicated that, in light of the free market nature of the Japanese economy, the Government could not force specific import targets.

The liberalization of the domestic money and capital markets and the complete opening of those markets to the rest of the world have been important goals of the authorities for some time. The latter aim was effectively realized with the revision of the Foreign Exchange and Foreign Trade Control law in December 1980. The array of assets available to investors, both foreign and domestic, will increase as progress continues to be made on the former goal. Despite the sharp deterioration of the capital account in 1982, the authorities resisted the imposition of capital controls, believing that such action--even if temporary--would inevitably have a detrimental impact on the longer-term development of Japan's capital markets.

V. Staff Appraisal

It is convenient to begin by recalling the salient features of the Executive Board discussion of the Japanese economy in February 1982; that discussion was wide-ranging and the policy prescriptions proferred by Executive Directors were varied--and sometimes conflicting. But underlying the various comments and suggestions were certain common concerns, some of which the Chairman summed up as the hopes of Executive Directors. These hopes were that domestic demand in Japan, which had been very weak in 1981, would recover in 1982; that inflation, already among the lowest in the world, would be contained further; and that Japan's current account surplus, threatening to grow sharply, would remain moderate. With trade frictions already becoming serious, Executive Directors wanted the Japanese economy to grow on the strength of its domestic demand and with lesser reliance on exports. Directors also urged the desirability of Japan continuing the process of opening up its markets to the rest of the world, not only for goods and services but also for capital.

Now, a year later, it can fairly be said that the Japanese authorities have indeed conducted their policies in a manner which is consistent with the hopes and urgings of the international community summarized above. The task has not been easy by any means. True, some exogenous developments have been favorable. The decline in oil and other raw material prices and the abatement of inflation in other industrial countries during 1982 have made it possible for the authorities to keep inflation low even as the depreciation of the yen through most of the year worked in the opposite direction. But, in general, the dominant exogenous forces bearing on the Japanese economy have been adverse or constraining. Very high interest rates in the United States until late summer of 1982 contributed to the weakening of the yen. The persistent sluggishness of economic activity and the associated increase in unemployment in the major industrial countries stimulated protectionist pressures against Japanese exports--pressures aggravated by the depreciation of the yen but themselves feeding back into and aggravating that depreciation. Notwithstanding the depreciation, Japanese exports fell noticeably in 1982, reflecting weak world demand and the restrictions, including voluntary restraints, placed on them. At the same time, the weakness of the yen not only constrained monetary policy from playing a suitably stimulative role, but also, under the conditions prevailing in 1982, adversely affected domestic demand through its impact on corporate profits.

Under the circumstances, the authorities have conducted their financial policies with substantial flexibility. This has been most evident in fiscal policy. When, during the course of the current fiscal year, it became clear that budgetary revenues would fall substantially below initial estimates, reflecting a slower growth of output than initially anticipated, the authorities decided to accept a larger deficit than originally projected rather than cut back expenditures to stay within the limits of the budget. Indeed, midway during the fiscal year, they adopted a supplementary budget that incorporated a set of measures designed to stimulate the economy. In this way, the authorities chose to lend support to economic activity in the short-run rather than to persevere with their medium-term objective of eliminating as planned the deficit financing of current expenditures. As for monetary policy, the authorities have sought to steer a careful course between the requirements of domestic economic growth and exchange rate considerations. In general, they have given due consideration to exchange rate developments in setting policy with regard to both interest rates and monetary aggregates. Also, they have intervened heavily at times in the exchange market to signal their displeasure with the depreciation of the yen as well as to deal with what they regarded as its erratic movements.

Helped by the underlying strength and resiliency of the Japanese economy and effective policies in other spheres such as industrial adjustment, the financial policies as sketched above have produced admirable results. Inflation has been kept low, but as inflation has now subsided in other industrial countries as well, Japan is no longer unique in this respect. Japan is probably unique, however, in the extent to which inflationary expectations have been desensitized in its economy; in no other major country can it be said that confidence in continued price stability is greater. Policies have also succeeded in achieving a rate of output growth that is likely to be around 3 per cent in 1982/83, considerably lower than earlier expected but only slightly lower than in the previous year and, in any event, surpassing the weaker growth performance of other major industrial countries. Most of the increase in output is the result, moreover, of an increase in domestic demand rather than being derived from foreign sources. Exports turned out to be surprisingly weak, and the current account surplus, which had been expected to increase sharply, has remained moderate. Following with a lag the decline in interest rates in the United States from mid-1982, the yen has appreciated markedly, as Japanese monetary authorities exercised caution in reducing interest rates notwithstanding considerable domestic pressures to do so.

Recently, the setting for policymaking in Japan has been changing. For one thing, the change of political leadership toward the end of 1982 has made possible a shift in emphasis in fiscal policy, although its broad thrust has not been altered. Second, the decline in interest rates abroad has contributed to some strengthening of the yen, although the authorities have been appropriately cautious not to ease their monetary policy given the still unstable and inadequate conditions on the exchange market. Third, continued price stability, the recent appreciation of the yen, and the apparent completion of the inventory adjustment that was taking place in 1982 are more conducive to a sustained strengthening of private demand--a strengthening that has proved elusive for the last several years. Finally, the prospect of a recovery in the world economy in 1983, even if a weak one, promises some easing of Japan's policy problems. The policy stance that is emerging in this new setting is characterized by an apparently marked tightening of fiscal policy and caution in the conduct of monetary policy, with emphasis on permitting a continued appreciation of the yen.

The austerity of Central Government expenditures for the next fiscal year is striking and, combined with tax policies in the proposed budget, indicates a restrictive stance for fiscal policy. Even with a less restrictive stance presumed for other levels of government, the public sector as a whole is not expected to contribute to the growth of the economy in the coming year. This is in marked contrast to the support it has provided to the economy in recent years. This policy stance must be assessed against the background of the medium-term aims of fiscal policy, the confidence and speed with which private demand can in fact be expected to recover, and the flexibility with which budgetary policy can or will be implemented should that recovery turn out to be weaker than is now expected by the authorities.

The objective of eliminating deficit financing of current expenditures by 1984/85 is now clearly unattainable and no new deadline of this nature has yet been set. If this implies a reduced emphasis in the future on the size of the deficit as such, on balance it seems to be a desirable shift. However, it should not detract from the appropriateness, as a medium-term objective, of the reduction of the Government deficits. These have increased sharply in recent years giving rise to an unprecedented increase in the stock of outstanding government debt and in the share of revenue committed to servicing that debt. Given the political decision not to increase the tax burden, it is natural that the Government should want to keep a strict control on expenditure, cutting back wherever possible, in part by eliminating inefficiency and waste in administration. It could be argued that it would be appropriate to try to stimulate economic growth beyond the 3.4 per cent now projected by the authorities by increasing government expenditures. However, such a proposal would have to be founded on difficult judgments as to the potential rate of growth of the economy and the extent of the gap which may exist between that potential and recent performance. Moreover, any such policy would likely risk even larger budget deficits in the short run inviting an uncertain response on the part of financial markets.

The principal issue with regard to budgetary policy for the next fiscal year is whether aggregate output can increase by 3.4 per cent if the Government proceeds promptly with the withdrawal of stimulus from the economy as it now plans. In other words, can private demand be expected to increase sufficiently, as the authorities now project, to make possible this rate of economic expansion? After rising unexpectedly strongly in the first half of last year, the growth of private consumption demand has weakened sharply again. Growth of overall activity in the July-September 1982 quarter seems to have been sustained almost entirely by increased government expenditure, especially investment expenditure, and some improvement in the foreign balance. Current indications and the implications of the revised official estimate for fiscal year 1982 are that despite some apparent pickup in housing and plant and equipment investment, the economy is at present--in the current and the last quarter--expanding at an annual rate of only 1 to 2 per cent. This situation, together with the uncertainties relating to the world economy cannot but render a forecast of the timing and strength of a pickup in domestic activity hazardous indeed, even with continued improvement in the factors mentioned earlier. Inasmuch as neither the international community nor the Japanese authorities themselves would want recovery in Japan to be heavily dependent on external demand, caution must be exercised to avert too rapid a withdrawal of the support that the government sector is now providing to the economy. It would be prudent to await some additional evidence of a strengthening of private consumption and investment spending before deciding that these sectors will be capable of carrying the main burden of economic expansion.

The practical implication of the cautious approach suggested above is that budgetary policy should continue to be implemented with an appropriate degree of flexibility as it has been in the past two years. At this stage--the very beginning of the fiscal year--what is indicated is probably some front-loading of government expenditures as in the past two years. If private demand does in fact pickup adequately later on, the tempo of government expenditures could then be allowed to fall back so as to be consistent with the budget projections. The authorities have demonstrated an ability to adjust expenditure in this fashion in previous years through adjustments in the pace of contracting for public works.

The need for flexibility in fiscal policy is underscored by the continued need for caution in relaxing monetary policy to support private demand, a caution dictated by exchange rate considerations. The low level of the yen against the U.S. dollar remains one of the most important problems in the international monetary system and further strengthening of the yen therefore remains appropriate. Despite the easing of monetary conditions abroad and the appreciation of the yen that has already taken place, the authorities have not relaxed domestic monetary policy lest the appreciation be thwarted. Some downward drift of market interest rates has been permitted, but monetary expansion continues to decelerate. Moreover, the authorities have refrained from reducing the official discount rate because of its significance as a signal. Since some further appreciation of the yen would be appropriate, if only to help diffuse the present serious trade frictions, monetary policy cannot be deployed to do all it could otherwise do to stimulate the domestic economy. It must be acknowledged, in any case, that the potential of monetary policy in this respect is not great.

As one of the major beneficiaries of the free trade system, Japan needs to play a leading role in reversing the protectionist tendencies currently plaguing the world economy. In this regard, the market-opening measures announced in the last 12 months are welcome; given the present difficult economic and political circumstances, their complete implementation is urgent. Japan already has the lowest tariffs on manufactured goods, but there is still a need to make effective the measures announced to improve import testing and approval procedures, to relax import restrictions on agricultural products, and to otherwise promote imports in order to broaden and deepen the access of foreign exporters to the domestic market. Measures such as these, together with a further strengthening of the yen, could help diffuse protectionist pressures abroad. In this connection, the staff continues to regret the restraints placed on Japanese exports. The expected recovery of the economies of the major industrial countries, albeit weak, will hopefully provide an opportunity to begin the dismantling of such practices.

The differences in the perception of policies or prospects noted in this report should not cloud the fact that, in any broad appraisal of Japan's performance, only high tribute can be paid to the skill and success that are evident in the management of the economy. The structural adjustments achieved in recent years are indeed impressive; the rapidity with which, in a highly inflationary world, prices have been stabilized and the way in which, in a dismally stagnant world, growth has been sustained, are achievements unmatched in the rest of the industrial world. Equally commendable has been the authorities' perseverance in their commitment to help low income countries of the world, despite the severe domestic budgetary constraints, and to continue the liberalization of the money and capital markets, despite the pressure posed by the periodically large interest differentials in favor of other markets.

Fund Relations with Japan
(As of December 31, 1982)

Date of membership:	August 13, 1952
Status:	Article VIII
Quota:	SDR 2,488.5 million
Fund holdings of Japanese yen:	SDR 1,436.2 million or 57.7 per cent of quota.
SDR position:	Holdings are SDR 1,895.4 million or 212.6 per cent of net cumulative allocation of SDR 891.7 million.
Gold distribution:	1,026,995.292 fine ounces.
Lending to the Fund:	
SFF:	The maximum commitment of Japan is SDR 900 million; net borrowing by the Fund as of December 31, 1982 was SDR 632.0 million.
GAB:	The maximum commitment of Japan is ¥ 340,000 million. The Fund's indebtedness to the GAB presently amounts to SDR 194.3 million; ¥ 292,750.1 million is still available.
Exchange system:	Since February 12, 1973, the yen has been allowed to float. The exchange rate as of December 31, 1982 was ¥ 235=US$1.
Last Article IV consultation:	February 14, 1982.

JAPAN

Basic Data

Population

Total population (June 1982)	118,378,000
GNP per capita (1982)	US$8,965 1/

	1981 (Per Cent Share)	1979	1980	1981	1982 2/
GNP		(In trillions of yen)			
At constant 1975 prices		181.1	189.8	197.1	202.4
At current prices		218.9	235.8	251.3	264.3
		(Percentage changes over previous year in constant prices)			
Private consumption	52.0	5.9	1.3	0.5	3.8
Private residential investment	5.5	-1.0	-9.4	-2.6	-1.9
Private equipment investment	17.2	11.8	8.0	5.6	2.0
Government consumption	9.5	4.3	2.9	4.6	3.0
Government investment	9.5	3.1	-3.2	5.3	0.6
Stockbuilding 3/	0.6	0.5	-0.1	-0.2	-0.1
Total domestic demand	94.3	6.4	1.2	1.9	2.6
Foreign balance 3/	5.7	-1.0	3.5	2.1	0.2
Real GNP	100.0	5.2	4.8	3.8	2.7
Nominal GNP	...	8.0	7.7	6.5	5.2
Prices and income		(Percentage changes over previous year)			
Wholesale prices		7.3	17.8	1.4	1.8
Consumer prices		3.6	8.0	4.9	2.7
GNP deflator		2.6	2.8	2.6	2.5
Nominal wages 4/		5.8	5.7	5.2	5.1
Real wage 4/5/		2.1	-2.2	0.3	2.4
Real disposable income 5/6/		2.4	-1.4	-1.0	3.6
Average propensity to consume (in per cent) 6/		77.6	77.9	79.2	79.2
Manufacturing (period average)					
Employment of regular workers		-0.5	1.0	1.1	0.7
Production		8.4	7.1	3.2	1.1
Productivity		7.7	5.6	2.3	0.8
Unit labor cost		-1.5	1.5	3.5	4.4
Unemployment (in per cent)		2.1	2.0	2.2	2.4
Inventory ratio (in per cent) 7/		77.4	85.4	89.3	90.8

Basic Data (concluded)

	1979	1980	1981	1982 2/
Financial aggregates	(Percentage changes over previous year)			
M2 8/	11.9	9.2	8.9	9.2
Domestic credit 9/	8.4	8.4	10.0	8.2
Public sector	10.5	9.1	13.0	5.2
Private sector	7.9	8.3	9.3	9.0
Central Government budget 10/	(Fiscal year basis, in trillions of yen)			
Revenues 11/	25.5	28.9	31.4	33.0
Expenditures	39.8	43.4	46.9	47.6
Deficit (-)	-14.3	-14.5	-15.5	-14.6
Fiscal investment and loan program	16.2	18.1	19.4	20.6
Deficit/GNP (in per cent)	6.4	6.0	6.1	5.5
Balance of payments	(In billions of U.S. dollars)			
Exports	101.2	126.7	149.5	137.7
Imports	-99.4	-124.6	-129.5	-119.5
Trade balance	1.8	2.1	20.0	18.2
Services and transfers	-10.6	-12.9	-15.2	-11.3
Current balance	-8.8	-10.7	4.8	6.9
Long-term capital 12/	-13.0	2.3	-9.7	-15.0
Japanese	-16.3	-10.8	-22.8	-27.5
Foreign	3.3	13.1	13.1	12.5
Basic balance	-21.8	-8.4	-4.9	-8.1
Short-term capital	9.1	13.2	9.1	3.2
Nonbank 13/	5.1	--	2.7	3.2
Bank	4.0	13.1	6.4	--
Overall balance	-12.7	4.8	4.2	-4.9
Gross official reserves 14/	(At end of period, in billions of U.S. dollars)			
Total reserves	20.6	25.7	29.2	24.3
In months of imports of goods and services	1.8	1.8	1.9	1.7

1/ At an exchange rate of US$1 = ¥ 250.
2/ Staff estimates.
3/ Contribution to real GNP.
4/ Manufacturing sector.
5/ Deflated by CPI.
6/ Workers' households.
7/ Index of producers' inventory ratio to shipment.
8/ Period average.
9/ End of period.
10/ Settlement basis for FY 1979 to FY 1981 and revised budget for FY 1982.
11/ Excluding sale of financial assets.
12/ Excluding Gensaki transactions.
13/ Including Gensaki transactions and errors and omissions.
14/ Including gold (national valuation).