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Correction 1

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INFORMATION

February 21, 1986

To: Members of the Executive Board

From: The Acting Secretary

Subject: Japan - Staff Report for the 1985 Article IV Consultation

The following corrections have been made in SM/86/24 (2/10/86):

Page 4c, Chart 4, lower panel: for "(U.S.-Japan)" read "(Japan-U.S.)"

Page 7, para. 1, last line: Insert two and half paragraphs inadvertently omitted.

Pages 8, 9, and 10: Reissued to include overflow of paragraphs.

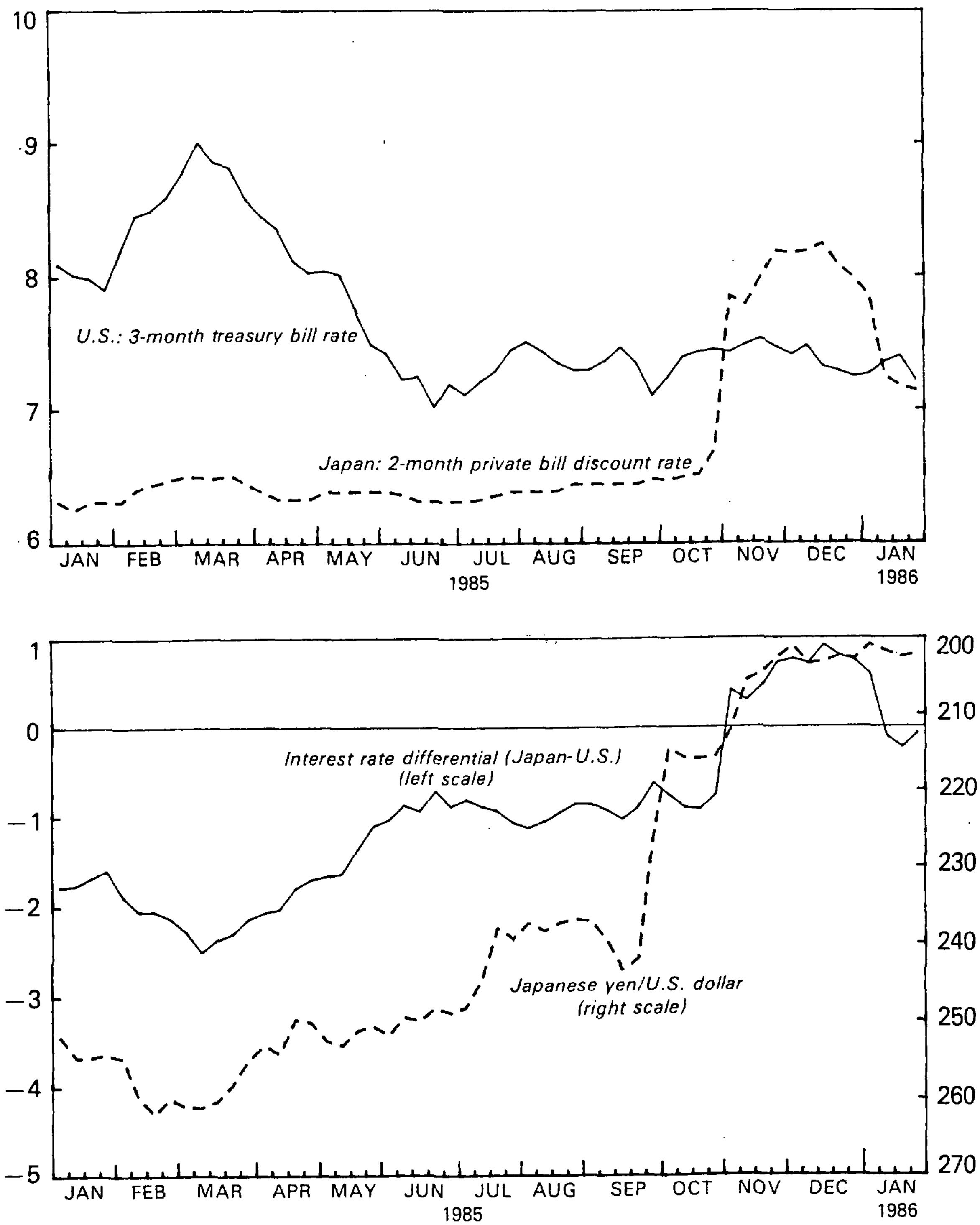
Corrected pages are attached.

Att: (5)

Other Distribution:
Department Heads

CHART 4
JAPAN

NOMINAL SHORT—TERM INTEREST RATES AND THE YEN/DOLLAR EXCHANGE RATE, 1985-86



Source: IMF, International Financial Statistics.

In the view of the staff, recent developments in the economy, the current stance of policies, and the external outlook point to a substantial slowing of growth in 1986/87. 1/ Staff estimates put GNP growth at 2.8 percent in 1986/87, 1.2 percentage points below the official forecast. Comparing the projections, the main difference arises in the outlook for domestic demand--more particularly in the estimates of private plant and equipment investment. In the staff's view, the prospect of weaker profits and stagnating exports, and the already considerable duration of the investment upswing point to a significant slowdown. High real interest rates would bring additional downside risk. Counterbalancing this are the possibility of some recovery in the electronics sector, the continuing need for technological upgrading and equipment replacement, and recently introduced investment incentives. Nevertheless, on balance, the staff expects a significant slowdown in investment.

The official and the staff forecasts both point to a strengthening of private consumption in 1986/87, but from different bases. Here, too, there are conflicting forces at work: real consumption would be expected to increase as a result of the expected improvement in the terms of trade, but this would be partly offset by the likelihood of somewhat lower wage growth and fiscal drag; the household savings ratio is projected by the staff to be unchanged. In the area of private residential investment, the staff expects a somewhat weaker response to recent stimulatory measures than incorporated in the official forecast, reflecting an expectation that the underlying structural factors restraining housing investment will persist.

With the appreciation of the yen and lower oil prices, the decline in wholesale prices has recently accelerated. Wholesale prices are expected by the staff to fall by 2.5 percent (annual average) in 1985/86 and by a further 2.7 percent in 1986/87. Consumer price inflation is expected to fall from 2.0 percent in 1985/86 to 1.3 percent in 1986/87. The increase in the GNP deflator is expected to fall to 1.1 percent.

The staff expects the current account surplus to amount to $55 billion (3.9 percent of GNP) in 1985/86, rising further to $59 billion (3.5 percent of GNP) in 1986/87. However, the increase is due to the falling international value of the numeraire; measured in yen terms, the surplus would, in fact, decline by 5 percent. In contrast, the official forecast is of $51 billion for both years. The increase projected by the staff reflects primarily the "J curve" effect of the recent appreciation of the yen and the assumed decline in oil prices. As a result, the terms of trade are projected to improve by some 7.5 percent in 1985/86 and by a further 5 percent in 1986/87. The stronger yen and lower market growth abroad would lead

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1/ Staff projections are based on the working assumption of a decline in crude oil prices from $26.7 per barrel in 1985 to $23.5 per barrel in both 1986 and 1987. The staff estimates that were oil prices to be lower by $5 per barrel, the current account surplus would, in the first instance, be some $8 billion higher. The impact on growth is more difficult to estimate, but it is unlikely that growth in 1986/87 would be substantially higher than currently projected. The staff is currently revising its economic forecasts in the context of the forthcoming World Economic Outlook exercise and these will be made available to Executive Directors prior to the Board meeting.

to a reduction in export volume growth to 3 percent in 1985/86, with no growth likely in 1986/87. In contrast, import volume growth of about 1 percent in 1985/86 would rise to about 5 percent in 1986/87 as a result of the stronger yen. Investment income receipts are expected to rise considerably in both 1985/86 and 1986/87, contributing to the widening of the current account surplus.

In sum, the authorities expect that domestic demand will strengthen sufficiently in 1986/87 to offset the disappearance of the external stimulus, so that output growth will remain more or less unchanged from 1985/86. The staff believes that domestic demand will continue to grow at about the same rate in 1986/87 as in 1985/86 so that output growth will slacken, fully reflecting the swing in the external position, to a rate distinctly lower than the potential growth rate of the economy.

2. The medium-term outlook

An assessment of the outlook for external adjustment and growth beyond 1986/87 must, of course, be highly tentative. Projections for 1987/88, based on end-1985 exchange rates and only modest increases in demand both in Japan and in external markets, suggest that Japan's current account surplus would stabilize in dollar terms, and decline further to 3.3 percent of GNP. By 1987/88, the "J curve" boost to export values arising from the yen's recent appreciation would wear off. GNP growth, at about 3.5 percent, would remain sluggish.

It is not possible, at this stage, to accurately chart the path of balance of payments developments in the medium term. However, it is instructive to explore, if only in a summary way, some of the forces operating on saving and investment flows, which underlie external prospects.

That Japan has a high saving rate is well known. For the period 1979-84, the private savings rate in Japan (gross private savings were equivalent to 27.7 percent of GNP) was substantially above that in the other major industrial countries (Chart 5). Household savings, which account for over half of total private savings, rose steadily in the 1960s and the early 1970s to about 18 percent of household disposable income. 1/ The rate jumped to almost 24 percent in 1974--when, with high inflation, savers strove to maintain the real value of their financial assets. However, it has since declined persistently, with the exception, again, of the period immediately following the second oil price increase. Abstracting from the sharp increases in 1973-74 and 1979-80, household savings peaked at a level of about 18.5 percent in the early 1970s, with a slow secular decline being evident since then.

1/ Although corporate savings make up a large part of gross private savings, their contribution in net terms, after allowing for depreciation, and their likely impact on developments in the balance between savings and investment, is much smaller.

A recent international cross-section study carried out in the Fund, 1/ confirms the importance of Japan's population structure in explaining the relatively high saving rate in line with the "life cycle hypothesis" of saving. The relatively low ratio of the aged to the working-age population appears to be the most powerful positive factor affecting household savings. However, the relatively high labor force participation rates for the elderly in Japan, which reduces the need for younger workers to save for their old age, appears to have a large offsetting effect. The practice of early retirement in the government and corporate sectors, even though most retirees remain in the workforce, the lower ratio of the young to the working age population, the lower level but more rapid growth of per capita income, and higher land prices also contribute to high savings in Japan. In contrast, the relatively low inflation rate tended to reduce the saving rate.

There is less clear evidence of the importance of financial factors. The Japanese tax system contains numerous tax incentives for saving, more than in other major countries. While the empirical evidence is not conclusive, tentative staff estimates suggest that the impact of these incentives on the level of household saving has been reduced over recent years. There is some evidence that the large lump-sum bonuses paid to workers twice a year, which move broadly in line with firms' profitability and account for about a fifth of total compensation, have tended to increase the saving ratio. The effects of the availability of consumer credit on saving are ambiguous in theory and difficult to ascertain in practice. 2/

The rapid aging of the population is expected to be the predominant factor influencing savings in the future, leading in time to a significant decline in the private saving rate. Other factors are the likely rise in the retirement age and a reduction in the labor force participation rate of the aged in response to increasing social security benefits. These last two developments would have broadly offsetting effects. Tentative staff projections indicate a gradual decline in the household saving rate by perhaps 4 percent of GNP over the course of the next 15 years as a result of these developments. Movements in the short term are more uncertain, being dominated by year-to-year macroeconomic developments, although measures to reduce financial incentives to saving and increase the availability of consumer credit on more attractive terms would be expected to have some immediate effect.

As in the case of savings, private investment has also been high by international standards. Private investment absorbed most of private savings until the early 1970s, and both rose steadily as a proportion of

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1/ "Why is Japan's Private Savings Rate so High" by Charles Yuji Horioka of Kyoto University, who was a consultant in the Asian Department in 1985. It is anticipated that this study will be issued in the DM series, and a summary will be provided in a supplement to the forthcoming paper on recent economic developments in Japan.

2/ Developments in consumer credit in Japan are reviewed in a supplement to the forthcoming paper on recent economic developments in Japan. Some of the theoretical arguments are discussed in the supplement on private saving referred to earlier.

GNP. However, private investment fell sharply following the first oil price hike, from 26.8 percent of GNP in 1973 to 20.6 percent by 1978, as the rate of return on capital fell and future growth prospects were scaled back. Since then, there has been a recovery in private investment on plant and equipment, especially in most recent years as new technologies have become available and growth prospects have improved. In contrast, residential investment languished, falling by the equivalent of 2 percent of GNP between 1978 and 1984 as rising land prices outpaced growth in household incomes, and other structural factors depressed housing demand.

There is, perhaps, even more uncertainty surrounding the future course of private investment than for savings. There are bound to be sizable fluctuations in plant and equipment investment in response to developments in economic activity, wages, and capital costs. Trends in such investment will be influenced by perceptions as to the likely future growth path of the economy, in which the pace of technological progress would be an important factor. The authorities' efforts to promote private sector initiative and freedom will also be important in this regard. The latent demand for housing investment would remain strong as housing becomes, more than ever, the area where basic needs are least well satisfied. Whether this will translate into a large enough increase in investment in housing will depend partly on the success of efforts to provide housing financing on attractive terms and deregulate land use, and other developments affecting land and housing costs relative to incomes.

A further important question is the impact of the stance of fiscal policy on private saving and investment behavior. The empirical evidence on this issue is not conclusive, but there is a broad consensus that changes in public sector saving are likely to be partially offset by changes in private sector saving and investment behavior. The Japanese authorities have sought to reinforce such offsetting effects mainly through structural policies to stimulate private sector vitality; these are discussed in Section V.4 below.

V. Policy Issues

1. General considerations

The Japanese economy has grown strongly in recent years without any indication that resource limits were being reached. In 1986, however, growth is expected to fall well below the economy's potential. Moreover, the prospect of further withdrawal of external stimulus beyond 1986 raises the risk that slower growth may persist.

The interests of the international community and Japan coincide in sustained, strong economic growth in Japan, near to its potential rate. The importance of strong noninflationary growth in the major industrial countries was given a central position in the Declaration of the May 1985 Bonn Economic Summit. It was reaffirmed in the Announcement of the G-5 on September 22, 1985 which included a commitment by the Japanese Government to continue policies intended to ensure sustainable noninflationary growth. Strong domestic demand growth in Japan is especially desirable, not only because of Japan's economic size and impact on the